S. HRG. 109–1057

THE OFHEO REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE OFHEO REPORT OF THE SPECIAL EXAMINATION OF THE WIDESPREAD PROBLEMS PRESENT AT FANNIE MAE

JUNE 15, 2006

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C O N T E N T S

THURSDAY, JUNE 15, 2006

WITNESSES

THE OFHEO REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE

THURSDAY, JUNE 15, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 10:33 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

This morning, the Committee will conduct an oversight hearing on OFHEO's report on the special examination of Fannie Mae. The report provides an unfortunately familiar story of a company plagued by fraudulent accounting practices, inadequate internal controls, and failed corporate governance.

OFHEO's report provides great detail on the widespread problems present at Fannie Mae. Congress, as we all know, chartered Fannie Mae to serve an important public purpose: that is, to build a strong and vibrant secondary market to strengthen our nation's housing finance system. In the hundreds of pages of OFHEO's report, we do not read about the noble mission of making homeownership possible for more Americans. OFHEO's report clearly proves that Fannie Mae has lost focus on its mission. It appears that their primary business mission was, in fact, to engage in earnings management in order to yield maximum possible executive compensation.

This is a company whose management developed an obsession with achieving performance targets, with little else seeming of consequence. In fact, so great was this obsession that the head of the Office of Auditing, ostensibly charged with ensuring accurate financial reports, was instead preaching Chairman Raines' goal of doubling earnings per share, telling his staff that they must have $6.46 branded in their brains, $6.46 branded in their brains. That even the audit staff was so compromised, one can only conclude that greed served as the sole force driving management's behavior.

It is also clear that more than one check on corporate misbehavior failed. The lack of attention and investment by the company in systems, internal controls, and risk management should be an embarrassment to this company, including the Board of Directors. The report also calls into question the role of the external auditor and the independence of the internal audit process.

The themes of this report should certainly resound in the ears of the Committee Members. This is certainly not the first time that we have heard of them. The overstatement of earnings, the lack of transparency, the inattention of the Board of Directors, and the near-record settlement with the Securities and Exchange Commission would pose a threat to the viability of many a private corporation.

Yet, there is one very tangible difference in the Fannie Mae story, and this difference is critical to our consideration of any regulatory reform proposals. Unlike other companies, which were felled by corporate misdeeds, Fannie Mae continues to operate in the capital markets as if nothing has happened. Wall Street analysts have not clamored to downgrade Fannie Mae debt, and the company continues to issue significant volumes of debt that domestic and international investors remain eager to buy and to hold.

These market conditions should make clear to the Congress that market discipline plays little if any role in policing Fannie Mae and by extension Freddie Mac. Because of the perception that these entities are implicitly backed by the Government, it is clear that we cannot count on the normal private market mechanism to temper the risk taking behavior of the GSEs. The GSEs' creditors have little incentive to pay attention until the point where irreparable harm has occurred, corrections are impossible, and the thin levels of capital have evaporated.

In other cases where the behavior of companies such as Enron, WorldCom, and others were egregious, this Committee acted to change the ground rules. We took vigorous action to protect the investors from similar behaviors in the future. The question now is how do we go about doing this for the GSEs? We must be mindful of the fact that these companies do not operate under the same set of rules that apply to other private companies. Thus, part of our regulatory effort must address the fact that market discipline is not present. For this reason, we must be sure that the regulator has the necessary authority and guidance from Congress to ensure that the GSEs stay focused on their mission, while minimizing their ability to take advantage of their special status by abusing their charter.

For our first panel today, we welcome two distinguished witnesses: Mr. James Lockhart, Acting Director of the Office of Federal Housing Enterprise Oversight, which we call OFHEO; and Mr. Christopher Cox, Chairman of the Securities and Exchange Commission. For our second panel, the Committee will hear from Mr. Daniel Mudd, Chief Executive Officer, Fannie Mae; and Mr. Stephen Ashley, Chairman of the Board of Directors of Fannie Mae.

I thank all of you for being here today to discuss some of these disturbing findings recently released by OFHEO. The Committee did invite two additional witnesses for the hearing this morning. We extended an invitation to Mr. Franklin Raines, the former Chief Executive Officer and Chairman of the Board of Fannie Mae. On the advice of his counsel, he has chosen not to appear, and I would like to include the response we received from his attorney in the record this morning.

The Committee also believes that it would be useful to hear from other members of the Board of Directors. OFHEO's report high-

lights the failure of the Audit and Governance and Compensation Committee of the Board of Directors. We did invite Mr. Thomas Gerrity, who headed the Audit Committee for a number of years, but he had a prior commitment and could not attend today.

We believe that it will be necessary to hear additional views from the Board members and perhaps from other entities, such as S&P, who rated Fannie Mae so highly on corporate governance less than 2 years ago. We will schedule this hearing as expeditiously as possible, and without objection, the letter from Franklin Raines' attorney, Mr. Kevin M. Downey's letter to me as Chairman of the Banking Committee advising that Mr. Raines would not testify will be made part of the record.

Senator SARBANES. Mr. Chairman——

Chairman SHELBY. You want to defer to Dodd?

OK; Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER DODD

Senator DODD. Well, thank you, Mr. Chairman, and I thank my colleague from Maryland. I will be very, very brief in these opening comments.

First of all, thank you, Mr. Chairman for holding these hearings and the timeliness of them as well and for our witnesses who will be testifying before us this morning. The abusive practices detailed in this nearly 350-page report are both disturbing and incredibly disappointing, to put it mildly. It is difficult to completely absorb the significant accounting irregularities, the pattern of earnings management, and the clear intent of enriching certain employees, widespread corporate governance failures, and the total failure of both internal controls and external oversight.

I view the measures taken by OFHEO in ensuring capital adequacy and safety and soundness of Fannie Mae to be wholly appropriate, and I commend the staff of OFHEO and you, Mr. Lockhart, for the work done by you and the people who worked with you on this effort. It is extremely important. I would also like to commend Chairman Cox, Christopher Cox, and his staff for their contributions to this effort as well, and we are anxious to hear your thoughts this morning.

In the consent decree, OFHEO and the SEC have provided a very clear set of directions to Fannie Mae and its Board to change the way that they do business, and it is my hope that these changes have already begun. And I probably should have said this at the outset, Mr. Chairman. I think we want to keep the distinction between the underlying purpose originally intended for these GSEs and the tremendous contribution they make to a very critical component of our economy, and that is in housing: the fact that 70 percent of adult Americans today own their own home, in no small measure, it is due to the work supported by these GSEs.

But confusing purpose with practices here, and what is at stake is the very point I just made: that if these GSEs do not start operating correctly, we may see the loss of this critical component to our economy. I am very worried about that. I know there are others who frankly have an underlying problem with the whole notion of Fannie Mae and Freddie Mac. I do not. I have deep concerns about what has occurred here, but I would hope in our analysis of this,

we do not destroy critical components of the housing industry as a result of our efforts here to clean up a very, very big and sloppy mess, to put it mildly.

So to you, Mr. Lockhart, and your staff, I commend you immensely, but I hope, Mr. Chairman, in the process of working through this, we do not destroy the critical component that these GSEs can play in such a vital piece of our economy.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR ROBERT BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman.

I appreciate the comments of my friend from Connecticut and generally agree with what he has said here. We have a common friend, long-time Washington observer who has said Congress, whenever faced with a crisis, has one of two responses: do nothing or overreact. And in this case, we seem to be headed toward doing both. I think we do need a strong regulator. I do think we need a piece of legislation, but I think we do need also to be careful that we do not overreact.

I know the press particularly keeps saying this is another Enron, which it clearly is not. Fannie Mae has taken its lumps. Fannie Mae is paying a very large fine. Fannie Mae is under a very, very strong microscope, which it needs to be. But it is still operating, which Enron was unable to do. It has not closed its doors. No criminal charges have been filed against its people as happened almost immediately after Enron, and let us understand, as Senator Dodd has said, it and Freddie Mac play a very significant role in the housing market. So let us not do nothing, and at the same time, let us not overreact.

Senator DODD. Well said.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL SARBANES

Senator SARBANES. Well, thank you very much, Mr. Chairman.

The report of the special examination of Fannie Mae issued by OFHEO documents a number of very serious problems at Fannie Mae. I will not enumerate them. In fact, Mr. Chairman, you have done so to some extent in your opening statement. But the report underscores clearly the necessity of maintaining, documenting, and being held accountable for strong and effective internal controls and other financial and risk management systems.

As the Chairman of the SEC, a former colleague of ours in the Congress, Chairman Cox, said in announcing the $400 million settlement with Fannie Mae, the accounting and fraud charges that the SEC is filing against Fannie Mae reflect the failure by Fannie Mae to maintain the kinds of internal controls that could have prevented what, in all likelihood, will be one of the largest restatements in American corporate history.

The professional staff at OFHEO have worked hard over the last 3 years to complete this thorough examination and to reach a consent order with Fannie Mae. Likewise, the staff at the SEC have made a very significant contribution to the resolution of this matter, and I want to thank all of them for their work. In the consent order, OFHEO has required the Board of Directors and senior man-

agement to take steps to improve corporate governance at Fannie Mae by requiring that the Board put in place policies and procedures to ensure appropriate oversight.

Among the mandates in the agreement are requirements that Fannie Mae maintain a chief risk officer responsible for directing the organization to oversee risk management throughout the company; maintain an independent internal auditor and require the auditor to report directly to the Audit Committee; maintain procedures directing the Chief Compliance Officer to report any information relating to possible misconduct directly to the Board of Directors in a timely fashion; maintain at least one Board member with sufficient technical expertise to fully understand the implications of accounting policies through financial statements; and presenting proposals for enhanced public disclosures of its performance and risk measures.

The governance requirements contained in the consent order are the result of ongoing oversight by OFHEO. It is imperative that the leadership at Fannie Mae implement these recommendations as quickly and thoroughly as possible, so the company can turn its full attention to meeting its mission of supporting the housing market and affordable housing in the United States.

By all evaluations, we have a financing system for the housing market that is sort of envied across the world in terms of what it has been able to accomplish, and we need to keep that, I think, constantly in mind. The GSEs play an important role in supporting the housing market and in helping us to obtain affordable housing. They have a very important public mission with respect to housing.

This public mission places upon them an obligation to meet high standards of corporate behavior, both with regard to their corporate governance and their business practices. Our objective must be to ensure that these standards are met so that the GSEs can meet their public mandate with respect to the nation's housing.

Mr. Chairman, I look forward to the hearing.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would like to join my colleagues in thanking you for holding this very important hearing. And like my colleagues, I was disappointed to learn that Fannie Mae manipulated the books so that executives could collect their multimillion dollar bonuses.

OFHEO's report laid out a shocking and disturbing picture of irresponsible behavior. Both Congress and the public are very concerned about the fact that a company with Government ties, the sort of organization that should be of the very highest ethics, perpetrated such a scheme. OFHEO's report demonstrates that we need strong, fundamental reform of GSE oversight, and we need it quickly.

I know that some disagree with the approach we took in Chairman Shelby's bill. Personally, I think it was the right approach and that the report demonstrates the need for the strongest possible reform. As to those who disagree, I think they should make their case on the Senate floor. If they can make their case, we will be able

to pass amendments. If they do not, then, they will not. Either way, we need to stop delaying.

Clearly, the status quo of accounting manipulation or simply an environment in which it was able to happen is the most unacceptable of all circumstances. I would also strongly encourage the Securities and Exchange Commission and the Justice Department to closely examine the circumstances revealed by OFHEO's report to determine if it is appropriate to bring criminal charges against those involved.

A failure of confidence in the stability and reliability of Fannie Mae could have dire consequences for a large sector of our economy. Just as we pursue wrongdoing in the private sector, it is even more important that we enforce responsible standards of Government-Sponsored Enterprises such as Fannie Mae. I look forward to hearing from our witnesses. Their testimony will be helpful as we continue our efforts to ensure this sort of thing can never happen again.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman.

We are here this morning to hear about the results of OFHEO's special examination of Fannie Mae. This report relates more of the details of the accounting scandal at Fannie Mae, describes how accounting transgressions, including inaccurate report of amortizations, a lack of documentation for account entries, and debt repurchasing to ensure earnings per share in subsequent years were used to create an appearance of an almost risk-free corporation with steadily increasing earnings year after year.

This report also sheds light on how many individuals and entities look the other way or simply fail to scrutinize Fannie's troubling course and confirms to me that Fannie was in need of stronger oversight, not only by its regulator but also by its Board, which is why this Committee has had hearing after hearing on what we can do to strengthen regulation and how to create a world-class regulator for Fannie and Freddie and the Federal Home Loan Banks.

This report confirms what we already know: that OFHEO or a newly created GSE regulator must have the funding, authority, and independence it needs to make sure that the GSEs are safe and sound and not posing unacceptable risks to the American taxpayers. At the same time, we need to make sure that any new regulatory setup enhances the GSEs' mission of making housing more affordable for millions of middle and lower income Americans.

At a time when housing is becoming less affordable, when homes are doubling in price every 6 years and incomes are increasing by a mere 1 percent per year, Fannie's mission is of paramount importance. Through a unique public–private partnership, Fannie Mae and Freddie Mac have succeeded in creating a considerable mortgage market in the United States. They have succeeded in facilitating the emergence of one of the highest homeownership rates in the world, and they have succeeded in allowing millions of Americans to own affordable homes.

In fact, Fannie and Freddie can do more, a lot more toward this mission. I have offered and if given the opportunity will offer again an amendment to the GSE reform bill that would improve and clarify Fannie's affordable housing goals. This amendment would also require Fannie and Freddie to create an affordable housing fund for underserved housing markets in our country.

Thanks in large part to OFHEO's oversight and the consent decree reached with Fannie, I am hopeful that Fannie Mae is returning to safe and sound business practices; that it is reconciling with the failures of its past; and that it is reemerging with a focus on its mission of affordable housing. I hope that the accounting failures at Freddie and Fannie Mae do not cause us to lose sight of the overall success of the GSEs' mission.

I look forward to the hearing and the testimony and thank you again, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

Mr. Chairman, what we are dealing with is an astounding, an astounding failure of management and Board responsibility, driven clearly by self-interest and greed. And when we reference this issue in the context of the best we can say is it is no Enron, now, that is a hell of a high standard.

[Laughter.]

Senator HAGEL. This issue needs to be dealt with, and just as the distinguished Senior Senator from Colorado noted, it needs to come to the floor of the Senate. And I hope the Majority and Minority Leader of the Senate or their staff are taking note of this hearing this morning and the testimony that will be presented, and I hope the Majority Leader and the Minority Leader get some sense of urgency and understanding what is involved here.

There is a story in the Wall Street Journal today that talks about the $11 billion in losses on derivatives that were deferred, hidden, mismanaged. You talk about not another Enron, I suppose; we are not there yet. We do not know. Chairman Greenspan and others who have served this country rather responsibly, Senator Bunning's notations notwithstanding.

[Laughter.]

Senator HAGEL. In all due respect to the distinguished Senator from Kentucky, we have been warned, this Committee has been warned time after time, year after year, about the systemic failure that is at risk here.

And my goodness: when will the Congress act? When will we find the courage to deal with this? I understand the significance of what these GSEs have meant for our housing industry; of course, that is the point, that is exactly the point, that we do not want to risk that. They have done incredibly good work for millions of Americans, and we are, just as the distinguished Senator from Connecticut noted, we are at risk in seeing that come unwound, and we may see, if we do not deal with this in a responsible way this year, that the future of GSEs is maybe over.

And I do not believe I overstate that. I, like any Senator, any elected official can say what we want. We have no responsibility for

anything. But the fact is that when you are dealing with this massive amount of fraud and mismanagement, something has to be done. And if we do nothing else around here, if we are elected to do nothing else, this is certainly something that would come within the purview of why we are here.

And I hope that with these hearings this morning and the more information that will be presented that the Majority Leader of the U.S. Senate, the Minority Leader of the U.S. Senate will understand the severity and the need to act on this, and this bill that we have produced in this Committee will be brought to the floor of the Senate and will be voted on this year. We will have a conference committee; we will have a resolution of this and put this fiasco behind us and solid, responsible management back on track for not only the citizens of this country and the taxpayers but for the housing industry.

Mr. Chairman, I look forward to our witnesses. Thank you.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Well, thank you, Mr. Chairman, and thank you to Mr. Lockhart and OFHEO and all of the work that has been done, and Chairman Cox, it is good to see both of you.

I think the challenge for us on this Committee is to not only to be able to understand that your report and the agreement and so on allows us to know what has happened, and the fact of the matter is there have been serious problems, serious issues, and Fannie Mae, Freddie Mac, our whole GSE system has an obligation to hold to the highest possible standards of corporate conduct.

But we also have a challenge in making sure we do not throw the baby out with the bath water, and I think that is what other colleagues have said, and I certainly agree with Senator Bennett, Senator Dodd, and others who have spoken about that balance that we really have to find, to act but not to overreact. And that is my concern as we move through this.

And as we look at this, I feel compelled to say that when Fannie Mae was set up in February 1938, it was set up to do exactly what they have done: to help families own a home, to be able to help families have the American dream. And to quote President Eisenhower back in 1954, he said this has been one of our major legislative goals. It will raise the housing standards of our people, help our communities, improve older neighborhoods, and strengthen our mortgage credit.

So despite—and in no way am I an apologist for what has happened, and there is no question that we have to focus on a strong regulator and on GSE reform, but I hope that we will also understand that the commitment to homeownership and the impact on Americans has been significant over the years. And more recently, I am very concerned about what has been happening as it relates to our country. There have been numerous warnings that a housing slowdown is on the horizon.

In fact, the most recent CPI numbers indicate that another increase in interest rates is just around the corner. This will put even more pressure on family budgets which are already squeezed, certainly in my State and other States as it relates to exporting of

our jobs and increased health care costs and energy costs, and I am very concerned that families who cannot afford the rate increases may find themselves without a Fannie Mae or Freddie Mac to turn to in order to keep their homes if we are not careful.

So, Mr. Chairman, I would just hope—I am interested in hearing about the changes that have already been made by Fannie Mae, changes that need to be made as well as a focus on their core mission, which has not changed, and I hope we will not take actions that will force them to change, because the families in this country right now need this opportunity as much as they ever have.

Thank you.

Chairman SHELBY. Thank you.

Senator Sununu.

STATEMENT OF SENATOR JOHN SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

We certainly welcome the witnesses, and I do not have prepared testimony, but I want to respond to a few of the points that have been made. First, with regard to overreaction: I am pleased to say this is one case where I think that it cannot be argued, and it cannot be argued effectively because this process did not begin 6 months ago or a year ago or 2 years ago.

This process of crafting legislation began 3 years ago, before anyone was talking about crisis or Enrons or anything else, when a few of us recognized that perhaps because we had worked on housing issues in the past or worked with OFHEO in the past on regulation that we just needed a stronger, better, more effective regulator with more staff, with more money, with better supervisory powers commensurate with those in other areas of the financial service industry.

So 3 years ago, Senator Dole, Senator Hagel, and I introduced legislation that contains most of the key core elements of the bill that this Committee has recently been discussing, and it has certainly changed since then. The fact is it has been a 3-year process, listening to those who would be affected by the legislation, listening to housing advocates, listening to other Members of the Committee. The Chairman, the Ranking Member, and their staff had a lot of suggestions in this legislation, and it has changed a good deal over those 3 years.

But the suggestion that we should all be concerned about overreacting I think is an argument for more delay, and I think it should be avoided. I think we should be serious and honest about our work, serious and honest about the amount of work that has already gone into this product, and we should be realistic about the importance of moving forward with legislation that has been very thoroughly discussed and vetted. And we may agree about or disagree with certain technical aspects of the legislation, but it has been well worked through the legislative process.

We would have completed this much earlier, at a much different time, and in an atmosphere that did not carry the suggestion of crisis if it had not been for the stonewalling of the GSEs and the stonewalling of their allies 3 years ago, 2 years ago, and 1½ years ago. I think recently, the work of the Committee has been substantive, and we have made good progress. But if you go back in

the record to 2 or 3 years ago, there was nothing but stonewalling on the part of the GSEs and their allies.

Second, concerns about the value of the GSEs, their housing mission, and the housing market: this is an issue on which all of us agree. And that agreement is not verified by what we happen to say here in front of the Committee. It is verified and validated in the legislation itself. The legislation does not change the charter or the mission of the GSEs one whit. It does not restrict it; it does not reduce it; it does not modify it. That charter and that mission, to provide liquidity in the secondary mortgage markets is affirmed, in fact, affirmed and reaffirmed throughout the legislation.

And perhaps the one area where we might make modification is in the important area that Senator Reed mentions, which is to expand that mission and charter where affordable housing is concerned, and I think that is an area where we have got a great deal of agreement, and we are going to end up. This legislation, I think, will and should end up with a provision very similar to what has been proposed by Senator Reed.

So to continually assert that we are concerned that we will hurt their mission or hurt their charter suggests that you have not read the legislation or that you are questioning the motives of all of the staff members and Democrats and Republicans who have worked on the legislation, and I think that is wrong, because we have reaffirmed the mission and reaffirmed the charter, and it is just simply wrong to set up a choice, that we have a choice between good regulation or a strong housing market. That is just simply wrong.

There is nothing in the provisions, the restrictions on portfolios or guidelines for the portfolios, enforcement or flexibility of the regulator to set capital limits, none of that affects or undermines the mission and the charter of the GSEs.

Third, the concern that this is not an Enron. I think Senator Hagel made a very fair point. There are differences, but as I read a suggestion that was made in a newspaper yesterday, perhaps the biggest difference at the moment is that the guys at Enron have been convicted. What we have here is a situation where there were $11 billion in intentional earnings misstatements that were designed to affect the stock price, affect bonuses, and, in effect, mislead shareholders and investors, all done at an entity where we all agree there is an implicit taxpayer guarantee. The implication is that taxpayers are on the hook.

So in terms of the concerns or the fears or the potential impact on the taxpayer, it is fair to argue that this is perhaps more significant or more grave than Enron. I think to a certain extent, we should step back from the rhetoric here, but we should recognize that this is very, very serious. People intentionally misstate earnings, manipulate earnings to mislead shareholders in a way that affects their own compensation and in a way that is arrogant and unethical and illegal, we have a problem, and it is magnified, not minimized but magnified by the nature of these institutions.

I put those concerns out to try to address some of the points that we have made. I think we have very good legislation here. It has been worked thoroughly; includes suggestions from both sides of the aisle. Everyone understands that the technical details of some of these provisions, whether they are the precise powers having to

do with capital standards or portfolio limits or the exact details of the affordable housing piece will be worked out in conference. But it is a serious mistake to continue to delay of this legislation at a time when the need for it, both from the perspective of the capital markets and the taxpayers, is greater than ever.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. I want to thank you, Chairman Shelby, for holding today's hearing regarding the OFHEO report. This report not only confirms my deep concerns about Fannie Mae; it demonstrates that the GSEs' actions were far worse than I could have imagined.

Nearly 3 years ago, as we have heard, after it was revealed that Freddie Mac had misstated its earnings, Senators Hagel, Sununu, and I introduced legislation to strengthen the regulation of the GSEs. And Fannie and Freddie responded, dispatching an army of lobbyists to Capitol Hill and spending tens of millions of dollars to oppose our bill. In 2004, their lobbying tab totaled $26 million and just last year, more than $24 million. At times, it has truly felt like David and Goliath.

No one has better described Fannie's mindset than the current CEO, who, in an internal memorandum of November 2004, asserted, and I quote, the old political reality was that we always won. We took no prisoners. And we faced little organized political opposition, end of quote.

Even today, after all that we now know about Fannie and Freddie, the GSEs' influence on the Hill remains strong. But we in Congress must stand up to any political influence the GSEs continue to wield. The facts speak for themselves: on May 23, the Securities and Exchange Commission concluded that, and I quote, between 1998 and 2004, Fannie Mae engaged in a financial fraud involving multiple violations of Generally Accepted Accounting Principles in connection with the preparation of its annual and quarterly financial statements. The SEC went on to explain that these violations had the effect, among other things, of falsely portraying stable earnings growth and reduced income statement volatility, and for the year ended 1998, of maximizing bonuses and achieving forecasted earnings, end of quote.

Some had earlier claimed that Fannie and Freddie's problems were an understandable misapplication of complicated, obscure accounting rules. We now know that this was not the case; that, in fact, Fannie and Freddie were committing fraud for many years, in part driven by certain executives' personal greed.

There can no longer be any doubt about what we must do here in the Congress. Fannie Mae and Freddie Mac need strong regulation to ensure that fraud and manipulation in their accounting practices have been forever banished from these institutions, and we need it now. This report represents a clarion call for the swift consideration and passage of legislation to create a new, independent regulator of these enterprises. This new regulator should have the ability to limit the sizable portfolios of Fannie and Freddie, thereby redirecting the GSEs to their original mission and

preventing them from engaging in activities that could undermine their safety and soundness or place them at systemic risk.

I thank both OFHEO and the SEC for their tenacious and diligent work on this issue. Director Lockhart, your report provides a complete and detailed expose, not only of the many complex transactions that underlay the problems at Fannie Mae but also of the broader culture of venality that developed at the GSEs. I thank you and the other witnesses for joining us here today.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Martinez.

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Mr. Chairman, thank you very much for holding this very important hearing on this very, very timely topic. I would like to make my prepared remarks a part of the record, but I really think——

Chairman SHELBY. Without objection, it shall be made a part of the record.

Senator MARTINEZ [continuing]. ——I should just speak about a little bit of the history of this.

And let me say that some years ago, not too many years ago, around 3 years ago, I guess, when my colleagues introduced a bill, I was sitting at the table testifying. It was as a result of some concerns that I had had and others in the current administration had had about the GSEs. And the concerns were greatly about the size of the GSEs, the implied guarantee, the fact that the taxpayers were on the hook, and they continued to grow exponentially, and also a concern that OFHEO was an inadequate regulator. Part of the GSE oversight was at HUD. OFHEO was under HUD but not really a part of HUD, and in fact, if you were to have wanted to design a regulatory scheme, which is still in effect today, by the way, that was fairly ineffectual, you would have designed exactly what was in place.

Now, as was just mentioned by Senator Dole, in fact, this was something of this culture of arrogance and disdain for regulation that permeated Fannie Mae. It was a culture that basically said we do not have to be normal, as noted by Mr. Mudd in his memo to Raines. We can write or have written rules that work for us, and that worked for a long time, and unless we pass this legislation, unless it comes to the floor and becomes law, that is still what is happening today.

But now, our concerns brought by my testimony and this bill that has been referenced was because we were concerned. But we had no idea what really was transpiring, what really was going on. We had no idea that the executives of Fannie Mae had given themselves, through manipulation of the stock price, bonuses and compensation in excess of $200 million. How many homes could Habitat for Humanity build if you were to give them a donation of $200 million? This was the compensation that was given to about four or five of the chief executives at this entity. One of them is the CEO today.

So what I would suggest is that there is great urgency, and I would not fear overreaction. I would fear underreacting to what is, in fact, a crisis for America's taxpayers who are on the hook. I

want to commend Mr. Lockhart, but also, I want to commend Armando Falcon, who was the head of OFHEO during the period of time when these initial reports were made with little staff and very little resources, because OFHEO was systematically starved from resources by the lobbying power of Fannie Mae for years to make it an incapable regulator, to keep it understaffed and undermanned so they could not do the job right, just like they, themselves kept their own financial staffs understaffed and their own financial system antiquated and complicated that they would turn up all of a sudden with a problem of $11 billion in magnitude.

When we talk about these not being an Enron, it may not be an Enron, but you know what it is? It is a WorldCom. WorldCom was a scandal of $11 billion. This happens to be $11 billion. The only difference between WorldCom and this, in addition to the fact that, you know, as Senator Sununu said, some people are in jail and others are not, is the fact that this particular company, this particular entity, was chartered to help America's poor find a place to live, and for that, the American taxpayer said we will be on the hook. There is an implicit guarantee; it is not a specific guarantee, but one that I know everyone around this table would know if these entities were to fail, the taxpayers of America would be on the hook.

So, Mr. Chairman, I am very much one of those who believes that we have to get this legislation through; that we have to ask the hard questions of current Fannie executives as well as the Board, and that we must give OFHEO the necessary powers so that they can be the regulator that we all believe they should be.

I look forward to the witnesses and thank you for the hearing.

Chairman SHELBY. Thank you.

Mr. Lockhart, Mr. Cox, we welcome you again. Both of you have been here and will probably be here many times.

We will start with you, Mr. Lockhart.

Senator BENNETT. Mr. Chairman?

Chairman SHELBY. Yes.

Senator BENNETT. Could I just make one quick sentence?

Chairman SHELBY. Sure, Senator Bennett.

Senator BENNETT. I would remind my colleagues I voted for the bill.

[Laughter.]

Senator BENNETT. Thank you.

Chairman SHELBY. Mr. Lockhart.

STATEMENT OF JAMES B. LOCKHART III, ACTING DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. LOCKHART. Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Thank you for the opportunity to discuss the findings of our Special Examination of Fannie Mae and the settlement agreement. It is a pleasure to be here with Chairman Cox, as the investigation and settlement agreements are excellent examples of government agencies working well together.

Before starting, I would like to mention that OFHEO will submit later today our Report to Congress on the 2005 examinations of Fannie Mae and Freddie Mac, which reinforces the message that

significant remedial actions are still needed at both enterprises. As Government-Sponsored Enterprises, they have unique positions among American corporations and an extremely important mission: facilitating the growth of affordable housing in the United States. Franklin Raines and his previous management team violated that trust.

By encouraging rapid growth unconstrained by proper internal controls, risk management, and accounting systems, they did serious harm to Fannie Mae while enriching themselves through manipulating earnings per share. The result was an estimated $10.6 billion of overstated profits, well over a $1 billion in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.

The report details an unethical, take no prisoners, corporate culture where the ends justified the means. The image of Fannie Mae as one of the lowest risk and "best in class" institutions was a façade. Senior executives were managing Fannie Mae in an "unsafe and unsound manner."

As you see in the chart, in order to receive maximum bonuses, senior executives hit earnings per share targets with uncanny precision by deliberately and systematically using inappropriate accounting and improper earnings management. Chairman Raines' 6-year compensation exceeded $90 million, of which $52 million was directly tied to achieving earnings per share targets. The inappropriate "tone at the top" spread. Incredibly, the Internal Auditor told his staff when discussing Raines' goal of doubling EPS that they had a moral obligation to "help him" and to help make "tangible contributions to Frank's goals."

Fannie Mae used a four-step approach to manipulating earnings: first, to prevent large, unpredictable earnings fluctuation, Fannie Mae implemented investment, derivatives, and other accounting standards to reduce volatility, and they did that while ignoring GAAP. Second, they went to extraordinary lengths to avoid recording losses on assets whose values had declined. Third, management then manipulated earnings to hit specific targets, using cookie jar reserves, income shifting transactions, and debt repurchases. And fourth, the report details the conscious decisions to use outdated accounting systems and to create a weak internal control environment which made it harder to uncover that manipulation.

The company's internal and external auditors failed to properly confirm compliance with GAAP, and even when KPMG became aware of the non-GAAP accounting practices, they continued to issue unqualified opinions. The last line of defense, the Board of Directors, failed to be sufficiently informed and independent. Their oversight failings meant that they did not discover, let alone correct, the multitude of unsafe and unsound practices, even after Fannie Mae's problems became apparent.

The Board approved bonus plans focused on managing earnings rather than risk. In 2002, Fannie Mae incurred billions of dollars in economic losses from interest rate risks. The operational risk losses were among the largest ever incurred. The settlement agreement has nearly 60 provisions designed to repair the damage and to prevent reocurrence.

Fannie Mae agreed to undertake a comprehensive reform program aimed at really top to bottom changes, including its Board of Directors, internal audit, risk management, compliance, internal controls, accounting systems, and external relations. Fannie Mae agreed to review current and former employees for remedial actions. Fannie Mae agreed to pay a $400 million penalty, and Fannie Mae agreed to freeze the growth of its portfolio mortgage assets.

The need for a settlement agreement full of so many remedial actions exemplifies why the report recommends strengthening OFHEO's regulatory process and supporting legislation to strengthen our safety and soundness powers. It is difficult to say whether the proposed legislation would have totally prevented the mismanagement, but I believe with the proposed legislation and proper staffing levels, OFHEO could have uncovered the problems well before such serious damage was done.

Thank you. I would be pleased to answer questions.

Chairman SHELBY. Chairman Cox.

STATEMENT OF CHRISTOPHER COX,

CHAIRMAN,

SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Chairman Shelby, Ranking Member Sarbanes, Members of the Committee. It is a pleasure, likewise, for me to be here. I appreciate the invitation but particularly to be here with Director Lockhart. His team at OFHEO has done, as you know, an outstanding job, and the Securities and Exchange Commission has very much appreciated the opportunity to work with them.

I would like to testify to the Securities and Exchange Commission's own recent enforcement action against Fannie Mae. I know that this Committee has spent a great deal of time examining the issues surrounding Government-Sponsored Enterprises, and I appreciate the opportunity to bring our point of view to the table. Since my written testimony contains many of the details of the accounting violations that our enforcement action was based upon, I would like to ask your permission to summarize that part of my testimony and then turn to——

Chairman SHELBY. Proceed.

Mr. COX [continuing]. ——important disclosure issues that I believe may be of interest to the Committee.

On May 23, the Commission and the Office of Federal Housing Enterprise Oversight——

Chairman SHELBY. Chairman Cox, could you bring the microphone just a little closer to you, please?

Mr. COX. On May 23, our Commission and the Office of Federal Housing Enterprise Oversight jointly announced settlements with Fannie Mae for accounting fraud. The Commission's action alleges that Fannie misstated its financial reports from at least 1998 through 2004. In settling these charges, as Director Lockhart mentioned, Fannie Mae has agreed to pay civil penalties totaling $400 million. The lion's share of these penalties will be returned to defrauded shareholders through our Fair Fund program.

Both Director Lockhart and I agree that a penalty of this size represents a meaningful sanction that is necessary to address the egregiousness of Fannie Mae's conduct. In addition to the $400 million in penalties, Fannie Mae will be permanently enjoined from future violations of the anti-fraud provisions of the Federal securities laws. It will also be subject to a permanent injunction against violations of the reporting, books and records, and internal control provisions of the Federal securities laws.

The significance of the corporate failings at Fannie Mae cannot be overstated. The company has estimated its restatements for 2003 and 2002 and for the first two quarters of 2004 will result in at least an $11 billion reduction of previously reported net income. This will be one of the largest restatements in American corporate history.

Fannie Mae's size and status make it a financial giant, but despite its prominent position in our financial marketplace, the company's internal controls were wholly inadequate for the size, complexity, and sophistication of Fannie Mae's business. Its failure in key areas highlights the critical need for senior management to constantly reassess the adequacy of internal controls as the business matures. That kind of attention to internal controls is necessary for the good of the business, for the protection of investors, and for the health of our capital markets.

Fannie Mae is a clear example that neglecting internal controls can be devastating for a company and for its investors. We are considering our investigation of the individuals and entities whose actions and inactions led to this result. The public should have full confidence that we will vigorously pursue those individuals who have violated the Federal securities laws.

Until the investigation is complete, I cannot comment further on the alleged conduct of particular individuals or the specifics of the investigation, but I would like to address several important and closely related disclosure issues. Fannie Mae's settlement of accounting fraud charges raises a very significant policy issue that I know has been carefully considered by Members of this Committee: Should the Congress require mandatory registration and periodic reporting under the Exchange Act by Fannie Mae as well as Freddie Mac and the Federal Home Loan Banks?

As you know, the securities issued by Fannie Mae are exempt securities under current laws issued by the SEC. But there is no question that the word "Government" in Government-Sponsored Enterprise leaves many members of the investing public with the mistaken impression that GSEs' securities are backed by the full faith and credit of the U.S. Government, when in fact, there is no such guarantee.

So we have a situation in which GSEs sell securities to the public. They have public investors, and they do not have the full faith and credit of the U.S. Government backing their securities, yet they are not required to comply with the disclosure rules under the Federal securities laws which exist for the protection of investors. That is why, going back at least as far as 1992, the Securities and Exchange Commission has consistently urged that GSEs should comply with the disclosure requirements of the Federal securities laws.

In July 2002, Fannie Mae announced that it would voluntarily register its common stock with the SEC under Section 12(g) of the Exchange Act. The registration of its common stock became effective on March 31, 2003, and Fannie subsequently began filing periodic reports with the SEC; but, after that, many of Fannie Mae's periodic disclosures have been late, incomplete, or not filed at all. Most notably, as of today, Fannie has not filed an annual report, its 10-K, for either 2004 or 2005, and it has not filed its quarterly report on form 10-Q for any of the preceding seven quarters.

I have no doubt that our recent enforcement action has focused the attention of Fannie Mae's management on improving its disclosure to investors. At the same time, there can be no question that, in the future, Fannie Mae would be far more likely to maintain consistent compliance with our disclosure regime if the Congress were to terminate its special status of voluntary registration and reporting and make its registration and reporting mandatory. That is a far better way to protect investors.

I know that this Committee is considering legislation that would require compliance with the Exchange Act reporting requirements by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I commend you for your attention to this issue and encourage your consideration of this legislation. We stand ready to support you in these efforts, and the Securities and Exchange Commission is prepared to enforce mandatory compliance should you choose to change the requirements for these Government-Sponsored Enterprises.

I also wanted to bring the Committee up-to-date on a related issue involving the New York Stock Exchange's listing requirements. The NYSE rules authorize suspension and delisting when a listed company fails to file its annual report with the SEC in a timely manner. As you know, because of Fannie Mae's failure to file its 2004 and 2005 annual reports, the NYSE amended its general delisting rules to provide a unique exception for Fannie Mae, even though it is not explicitly phrased in these terms.

Since the NYSE put this new rule in place, questions have been raised about whether the exemption is appropriate. As I testified before this Committee in April, the exemption needs to be considered in light of the unusual circumstances not only of Fannie Mae's voluntary transition to Exchange Act financial reporting compliance but also its requirements for a massive restatement.

As I testified then, however, this exemption must be temporary and only for the purpose of allowing Fannie Mae to come into initial compliance with Exchange Act reporting. To respond to concerns that this exception might become a permanent rather than a temporary policy, I want to inform the Committee that we have encouraged the New York Stock Exchange to amend its rule to put an expiration date on this exception. That way, Fannie Mae and its investors will understand that we expect Fannie, like any other listed company, to remain in full compliance with NYSE listing standards.

The Commission's action against Fannie Mae, our support for mandatory GSE registration and reporting under the Exchange Act, and our support for an expiration date on Fannie's unique exception under the NYSE's listing rules are all animated by the

same principle: that investors are best served by applying the Federal securities laws in an evenhanded manner to all companies participating in the public markets.

Thank you again, Mr. Chairman, for giving me the opportunity to testify today, and I am pleased to respond to any questions the Committee might have.

Chairman SHELBY. I will start with you, Mr. Cox, but I will address it to both of you.

With most private companies, we rely on market participants to raise questions and send alarms when numbers for a company do not look right. Likewise, we anticipate that most private companies cannot remain unscathed in debt markets or in dealings with their customers when scandal taints that company. But with reference to Fannie Mae, at least one analyst indicates that he places, and I quote, very little risk on delisting and expects a lot of regulatory forbearance, end quote.

Chairman Cox, given that the GSEs have an advantage that other private companies do not, how can we tailor a regulatory structure to pick up where market discipline might leave off?

Mr. COX. Mr. Chairman, these GSEs have been around for awhile. We have a lot of experience with their strengths and now their weaknesses. I think what we want to do is attract all of the strength and support that market discipline can provide. After all, these are public entities that are taking capital from the public.

I would commend you for the focus that you have on strengthening the regulatory side. I think we also need to strengthen the market side. The regime that we administer at the Securities and Exchange Commission is in the main a disclosure regime, and so great emphasis needs to be placed on getting out good, high quality information about these enterprises to the public. We have failed in that respect, I think it is very, very clear with Fannie; and, if we are to get on the right track, we need to make sure that normal market disciplines apply in the future.

Chairman SHELBY. Mr. Lockhart, do you have anything to add?

Mr. LOCKHART. The only point that I would add is if these companies were not Government-Sponsored Enterprises, the end might be significantly different than it is today. If it had been a financial institution, they would have lost their debt ratings and that would have been unfortunate.

Chairman SHELBY. Chairman Cox, some people have questioned whether any real harm has resulted from Fannie Mae's conduct. We hear this. If one buys into this argument, it would suggest that under certain circumstances, some amount of fraud is acceptable, even fraud that results in a $400 settlement with the Securities and Exchange Commission. You are the Chairman of the SEC. Is there some level of fraud that is acceptable in corporate America?

Mr. COX. Our job at the Securities and Exchange Commission is to police the markets against fraud.

Chairman SHELBY. All fraud, right?

Mr. COX. Of course, of course, and I think it is not so much a matter of accepting an argument in this case as it is noticing that what is attempting to pass for an argument is an egregious misstatement of fact. There was harm. It is objectively measured. Investors paid for $11 billion in earnings that were not there. A

company with $47.5 billion in market capitalization chartered by the Congress, a private company with a public mission, as it calls itself, was for a period of several years raising capital on the basis of financial statements that were the result of fraud. Its senior management was manipulating earnings and did so to enrich themselves.

The harm to investors is both direct and measurable. The stock price of Fannie Mae fell from over $75 to very recently under $49. As Director Lockhart has pointed out, they have spent over $1 billion thus far just trying to fix some of these problems. That is investors' money.

The harm to the markets, the diminution in confidence, is broad and immeasurable. Perhaps, as Senator Sununu pointed out, the gravest potential harm would be to the taxpayers if Fannie Mae were to fail, because Fannie has long traded on the mirage of the full faith and credit of the Federal Government backing those securities when, in fact, no such guarantee exists.

Chairman SHELBY. Mr. Lockhart, some other people would contend that Fannie Mae's improper accounting and earnings management never represented a risk to the safety and soundness of Fannie Mae itself or the financial markets. I personally believe it has simply been a matter of luck. It is clear that a great deal of management's focus was on earnings targets and not much else. I also believe that it was simply fortunate that we learned of the fraudulent practices at Fannie Mae before more serious safety and soundness issues arose.

How would it be possible that fraudulent accounting and a lack of internal controls would not pose a threat to safety and soundness for any financial company?

Mr. LOCKHART. It would be impossible.

Chairman SHELBY. It would be impossible. Thank you.

Chairman Cox, corporate governance. In January of 2003—I believe it was January 2003—Standard and Poors, S&P, assigned the company a corporate, that is, the company, Fannie Mae, a corporate governance score of 9, when 10 was the highest possible score. S&P said then that Fannie, quote, is not only demonstrating its own strong governance practices, but it is also showing leadership in the United States with regard to providing greater openness and disclosure about its corporate governance standards, end quote.

The company received the highest possible score in the areas of board structure and processes and financial disclosure. Fannie was the only company among S&P's first 10 clients to make its corporate governance grade public. It also paid, of course, for this rating. In retrospect, Mr. Lockhart, Mr. Cox and Lockhart, in retrospect, what do you make of this sterling review by SEC? Chairman Cox, obviously, they were way off the mark.

Mr. COX. I think that, when we answer that question in retrospect, it is very easy to see that the rating was not deserved. I think S&P, were they to be able to write their report in the light of what we all know today, under no circumstances would issue it. So I think what we have highlighted here are some of the inherent inadequacies of fortune telling when it comes to the job that these rating agencies have. I think the same can be true with respect to

the financials of Fannie. I mean, obviously, anybody who was evaluating them on the basis of those financial statements had to contend with the fact that we now know that, to a certain extent, they were fraudulent.

Chairman SHELBY. Mr. Lockhart, do you have any comment?

Mr. LOCKHART. Well, I agree on the S&P report. Obviously, they were wrong, and it probably should have been a 0 or a 1, as it turned out. But there were some obvious things that were there; for instance, the Chairman and the CEO was the same person, and we made sure that that is not going to happen in the future with these two entities, and there is a lot of corporate governance in the settlement agreement, as you know, that we did with both Freddie and Fannie, and we are going to stay on top of it.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Lockhart, this Committee has reported out your nomination, as you know, unanimously, and it is pending over on the Senate calendar now and presumably will be taken up in the very near future. Now, you have been the acting director at OFHEO now for 2 months or so?

Mr. LOCKHART. About one and a half.

Senator SARBANES. One and a half months. What is your sense of how on top of this situation OFHEO is?

Mr. LOCKHART. At the moment, I have been very pleased with the team. Many of them have been hired since the problems occurred 3 or 4 years ago. We built up—we have probably doubled the staff since then. We have hired a lot of experienced bank examiners. We have two teams now and they are in Fannie and Freddie every day looking at the issues.

So I have been pleased that we have been making some good progress, but also, I have to tell you I am convinced that we do not have all the tools we need, and that is one of the reasons we are obviously supporting the legislation.

Senator SARBANES. Well, we are trying to sort out those tools here in the Committee when we considered it, and in fact, I think there was a unanimous position with respect to many of the tools that have been suggested being provided to OFHEO. There are some differences that remain. Many of us think an affordable housing provision is extremely important. That is not in the Committee-reported bill, and then, there are some questions about portfolio limitations which raise important issues. I wanted to ask you about that.

As I understand it, the consent decree that was arrived at with Fannie Mae freezes the portfolios at the end of the year 2005 level. Is that correct?

Mr. LOCKHART. That is correct.

Senator SARBANES. And then provides that this growth limitation shall expire when the Director determines that it is appropriate to let them grow again, based on information regarding capital, market liquidity issues, housing goals, risk management improvements, outside auditor's opinion that Fannie Mae's consolidated financial statements present fairly in all material respects the financial condition of the company, receipt of an unqualified opinion

from an outside audit firm that Fannie Mae internal controls are effective pursuant to Section 404 of the Sarbanes-Oxley Act.

Now, I take it from this language, and the agreement also says that you will allow Fannie to grow even ahead of meeting those conditions a moderate amount per annum; I take it an adjustment as inflation goes or something of that sort?

Mr. LOCKHART. No, what it says is that they can come forward with a plan in 60 days, and we will look at it. But again, it is at the discretion of the Director whether we agree to the plan. There is no automatic acceleration.

And I want to put in context why we put that limit in. This company has serious internal controls, risk management, and operational risk problems, as well as accounting systems problems, and we felt it was just imprudent to let it continue to grow until it has fixed those problems.

Senator SARBANES. Yes, I understand that, and it seems to me a fairly prudent and rational thing to do. But the point is that these controls, as I understand it, are to stay in place until such time as you are convinced that the company can grow in a safe and sound manner, as demonstrated by the fact that it is well enough capitalized, is meeting its legal obligations with regard to its housing goals, and can demonstrate and document that the company is being run in a safe and sound manner, is that correct?

Mr. LOCKHART. That is correct, sir.

Senator SARBANES. Now, I also wanted to ask you about, in this effort to sort of see how we are doing and where we are getting, whether things are under control and so forth and so on; the report notes that Fannie's strategy was to match between 50 and 60 percent of the optionality of its mortgage assets with comparable options on the liability side.

This indicates that the company was taking on a lot of interest rate risk, which was reflected in some significant increases in Fannie's duration gap, which reached as high as 14 months at one point.

Mr. LOCKHART. Right.

Senator SARBANES. Can you tell us, without revealing confidential information, whether or not Fannie is more closely matching now its assets with its liabilities? I have heard reports that the duration gap now, like Freddie's, where I do not think this was really any significant issue at Freddie, is now between 0 and 2 months; is that correct?

Mr. LOCKHART. That is correct, Senator. They have narrowed the duration gap significantly since then.

Senator SARBANES. And this is a matter, I take it, you all are following very closely.

Mr. LOCKHART. We get weekly capital reports from the company. As I said, we have examiners in there every day, and we are following it very closely. We are also looking at the hedging activity on the optionality as well.

Senator SARBANES. What is your view of how well they are moving and how quickly on putting into place a system of internal controls? I mean, the report says that they were grossly inadequate; in fact, contravened supervisory standards, and I know a great deal

of focus has been placed on that. What progress is being made in that regard?

Mr. LOCKHART. Certainly, some progress was being made in both companies, but they have a very, very long way to go; a couple of years, really, 3 years, and as you will see in the report that we are putting out today, the annual report where we do the report of the examinations of the two companies, we do show there are a lot of issues these companies have to face, in the controls, accounting, risk management, human resources, getting the people there. They have a whole series of issues, and it is going to take several years to correct.

Senator SARBANES. What are they falling short in doing in terms of moving on this front? I mean, obviously, you need, like Chairman Cox—I forget where he was—recently gave the speech in which he emphasized the importance of an effective system of internal controls, not just in this instance but for all companies. What more, if anything, can be done to get there, or is it just it cannot be done overnight, and it is a time problem we have to work through?

Mr. LOCKHART. A lot has to be done. As Chairman Cox mentioned, neither of these companies are timely reporting at this point, so they are not getting their accounts out. From the internal controls standpoint, they are not even close to conforming with Sarbanes-Oxley at this point. Again, it is going to take several years to get there. They have lots of consultants. They have a lot of people and a lot of manpower devoted to these issues, but these companies were so poorly run that it is going to take many years to fix.

Senator SARBANES. Meanwhile, I presume OFHEO is monitoring that situation very closely. You now have your people sort of in the company day by day; is that right?

Mr. LOCKHART. We have people in the company day by day, our examination teams, and I can tell you that we have meetings at all levels with those companies on a very regular basis. But we are still, I have to tell you, occasionally finding problems; *i.e.,* there are still control problems that we are discovering even in the last several weeks.

Senator SARBANES. Mr. Chairman, I see my time has expired. Thank you very much.

Chairman SHELBY. Thank you.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Lockhart, does the consent decree deal at all with compensation methodology?

Mr. LOCKHART. Well, we have the powers to review the compensation of executives.

Senator SUNUNU. But as part of the agreement, were there any limitations or restrictions placed on compensation policy?

Mr. LOCKHART. We will review any changes, and we have told them, and they have agreed, that they have to change from the EPS-only bonus plan to one that covers a lot more areas.

Senator SUNUNU. Are there any members of the executive team today that are compensated in any part based on earnings per share or stock price?

Mr. LOCKHART. Last year, there were no bonuses paid at the company. This year, I am not sure what the plan is, because I have not seen it yet, but I assume from what they have told me that there may be some EPS, but it will be a much smaller part.

Senator SUNUNU. We have heard testimony here before this Committee, and it has been presented in other Committees as well by the past Fed Chairman and others in the regulatory environment that the powers proposed in the legislation addressing the guidelines for the GSE portfolios would not have any negative effect on their mission; specifically, the Fed provided material to this Committee showing that the size of the portfolios had no impact on availability of 30-year mortgages, on mortgage rates, or in the area of providing a critical buffer in cases of financial crises.

Do you agree with that assessment that has been made by the Federal Reserve?

Mr. LOCKHART. I generally agree. I have not looked through all the details, but yes, I do. You have to think of these companies as really two lines of business. One is packaging mortgages and securitizing them, and that, under the legislation, would continue to grow, and one is just really a substitute for the other: buying the mortgages and keeping them or just buying them and securitizing them. So certainly, if they continue to securitize mortgages, they will support the housing market.

Senator SUNUNU. Chairman Cox, in your testimony, you talked about the stock exchange rules, the New York Stock Exchange rules regarding delisting. You note that you have encouraged the New York Stock Exchange to amend its rule to put an expiration date on the exception it has provided to Fannie Mae regarding delisting procedures.

What is the mechanism for that encouragement? Has there been any formal communication or formal request from the SEC to the NYSE to establish a fixed duration, an expiration

Mr. COX. Yes; the communications between the SEC and the NYSE are taking place at the professional staff level. In addition, Chairman Thain and I have had these discussions directly.

Senator SUNUNU. What specific duration do you recommend that they impose on the exception?

Mr. COX. Our discussions are general at this point. What we have agreed is that while we are not trying in any way to precipitate or force delisting, we want to be sure that both Fannie and its shareholders understand that there are consequences for failure, and we want to provide every encouragement to get Fannie into a position where it can be Exchange Act compliant and thus compliant with the NYSE listing standards that apply to every other listed company.

So we will move forward on this as quickly as we can. I have been having these discussions as well with other Commissioners, and we will report back in real time.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman.

Mr. Lockhart, I think that the issue that is dividing the Committee in terms of the language of the bill turns on this notion of systemic risk. Operational risk, I think we understand. That is es-

sentially the focus of this hearing, whether the organization is run well, whether the Audit Committee operates, whether the outside auditors are there, and I presume, based on your agreement with the company, that you have essentially at least established in your mind that this operational risk issue has been handled effectively at this point; is that fair to say?

Mr. LOCKHART. No, I would not say that. They have not handled the operational risk yet. They are putting plans in place to handle it. I do not think, for instance, that they actually have a good operational risk capital model at the moment, and they certainly are not complying with Sarbanes-Oxley; they are not there.

Senator REED. But you are confident that given the framework that you have established, that you will be able, through your regulatory authority, to achieve that? Are you that confident?

Mr. LOCKHART. I am hopeful, yes.

Senator REED. Now, the other risk that they run constantly is interest rate risk. And that goes to their hedging activities, *et cetera.* You are looking into that, too, and you have provided for that?

Mr. LOCKHART. We certainly look at their market risk, their interest rate risk, yes, and their credit risk also.

Senator REED. And their asset risk also?

Mr. LOCKHART. Yes, that is credit risk basically.

Senator REED. Now, we are in this category of systemic risk. Assuming you have covered all of these other risks, what do you mean by systemic risk? And I ask the question because I think it is the question that might divide us.

Mr. LOCKHART. Well, I think systemic risk is a very big issue for these two companies, primarily because they are so large, and they represent such a large portion of the financial markets in this country and the housing markets.

There is no doubt in my mind that these companies are highly leveraged and more highly leveraged, potentially, than any other financial institution in this country. They have $1.5 trillion of debt outstanding, and they have used that debt to buy $1.4 trillion of assets. To hedge those assets, they have $1.3 trillion of derivatives, and on top of that, they have $2.6 trillion in guarantees. And that is all built on a combined capital of only $75 billion.

This is a very large exposure, built on a very small capital base. And so, a systemic risk means what happens if there is a problem in the financial markets, and could these companies cause such a problem? We are certainly very hopeful that they will not, but I do not think we necessarily have all the protections built in at this point.

Senator REED. And correct me if I am wrong, but my numbers suggest that in terms of their retained portfolio, it is about 14 percent of the overall market, which is not trivial, but that leaves 86 percent of the market controlled by hundreds of other entities, some regulated, most regulated, and some, presumably, not regulated. So I think in this regard, there is also a systemic risk on the other side, outside of this company, which is regulated presumably by the Fed and by others.

Mr. LOCKHART. This is a concentrated risk. These two companies represent 40 percent of the mortgage market in this country. The 15 percent that you mentioned is on mortgages that they own and

about 26 percent on the guarantees. So that is a very, very large exposure. Systemic risk can potentially be on both.

Senator REED. Absolutely. But the focus, I think, of this legislation is on their retained portfolio; is that correct?

Mr. LOCKHART. Right, and one of the reasons is because not only is it a retained portfolio; there are the derivatives that go with it.

Senator REED. Yes.

Mr. LOCKHART. So it is a double exposure, if you will.

Senator REED. But I think, just trying to think clearly, and I think when we talk about the systemic risk, and this is a serious topic, obviously, but I think we have to be very careful. On the other side, the mortgage-backed security side, where they do have 26 percent of the market, you seem to be less concerned about that in terms of systemic risk; is that——

Mr. LOCKHART. We are less concerned about that, but you have to look at the whole ball of wax, if you will, and I think there is more risk on the portfolio side, and as you know, the portfolios have tripled in market share in the last 15 years; in fact, at the peak in 2003, it was quadruple the market share. They were up at about 20 percent. I think that is a serious issue that should be addressed by Congress and the regulator.

Senator REED. Well, I guess, I think it is a serious issue. But typically, the way we have addressed this issue with respect to the Federal Reserve is to give them the tools with respect to the safety and soundness issue, raising capital, *et cetera.* I do not think we have given them a category of systemic risk which they can sort of improvise or, you know, innovate in terms of regulation.

I say this not suggesting it might not be appropriate, but I do not think we have yet understood precisely what tools you want, precisely what the risks are. In fact, the systemic risks posed to many companies is a huge deficit by the Federal Government and the interest rate policy by the Federal Reserve. That is pretty systemic, but I suspect you are not asking for that authority.

Mr. LOCKHART. What we are asking for—and I think the Senate bill covers a lot of the issues, as does the House bill—are stronger safety and soundness; obviously, we need that. We need stronger capital powers, part of which could address systemic risk, and we need to look at these portfolios to see if they need to be as large as they are.

Senator REED. Do you think the Federal Reserve needs those same powers when it looks at the portfolios of Citigroup and Bank of America and others?

Mr. LOCKHART. I think that they can control the growth of those companies. In fact, in the case of Citigroup, I think they were told not to grow awhile ago.

Senator REED. But that is based upon, and I do not want to belabor this, it is based on the existing powers. Here is where I think the dilemma is: I do not think there is a big debate about giving you the financial powers that the Fed has, that the OCC has with respect to national banks and others. It is just what do you mean by this systemic risk? Is this an undefined term which you will make of it is what you want to? And I think that is the real issue, a substantive issue, a principal issue that we have to sort out amongst ourselves, and we need more guidance from you.

And my time has expired.

Chairman SHELBY. Thank you, Senator Reed.

Senator Dole.

Senator DOLE. Chairman Cox, you stated that Fannie Mae would be far more likely to maintain consistent compliance with our disclosure regime if the Congress were to terminate its special status of voluntary registration and reporting and make its registration and reporting mandatory. Does this mean that the SEC now supports full GSE compliance with the 1933 and 1934 securities acts, and if not, why not, and what provisions are you suggesting should apply?

Mr. COX. I focused in my testimony, and indeed, the SEC has focused in more than a decade-long look at this issue, on the Exchange Act reporting obligations rather than the 1933 Act. They are essentially the same kind of information, and what we are concerned about is getting that information to the marketplace. I think there is an additional layer of issues that you might want to consider as you consider application of the 1933 Act: specifically, what effect, if any, would that have on costs? And would that, in turn, translate into directly or indirectly higher mortgage costs?

If the cost-benefit tradeoff is determined to work satisfactorily, then, there is certainly no conceptual reason that the 1933 act requirements as well as the 1934 Act requirements should not be applied. And I would point out that, if currently Fannie were subject to the 1933 Act, it would not be able to issue any securities, because one of the requirements is that you be current in your 1934 Act reporting requirements, which, of course, they are not.

Senator DOLE. As you have said, in all likelihood, this will be one of the largest restatements in American corporate history. Given that fact, how can the New York Stock Exchange, how can the SEC permit the stock of Fannie Mae to be traded without additional disclaimers or warnings to investors that there are still no current financials for this company?

Mr. COX. Well, I think that those have to be and are being transmitted. There have been several 8-K filings by Fannie. One of the things that we want to be sure of and that the NYSE clearly wishes to be sure of is that that kind of current information is being provided to the marketplace. It is entirely because of the unique circumstance by which Fannie, starting in 2002, determined voluntarily to subject itself to these requirements that we find ourselves in this unusual spot.

But, as I mentioned, I think it is very important that we focus on the "why." And the reason that the New York Stock Exchange has amended its listing standards with respect to Fannie is so that we can get them into compliance, so that they could make the transition to both registration and reporting under Section 12 of the Exchange Act.

It is a little bit of jargon, but the purpose of that is to protect investors. I mean, there are shareholders whose interests are paramount, and we want to be sure that they have liquidity, they have a place to trade, that we do not drive up their cost, and so on. And so, to the maximum extent possible in protecting their interests, we want to get the show on the road; get Fannie compliant.

Senator DOLE. Thank you.

On page 5 of your written statement, you note that Fannie Mae did not have adequate systems or personnel in place to comply with FAS 133. Yet Congress, investors, and American taxpayers were told repeatedly that Fannie Mae had world-class controls and disclosure. Was that assertion based on ignorance, or was it a blatant lie? I do not know which is worse, but both scenarios are outrageous.

Mr. COX. Well, I think we were ignorant, the public, investors, the market, because some people were intentionally manipulating Fannie's earnings, both with respect to FAS 133, as you mentioned, and also FAS 91.

Senator DOLE. Let me direct this question to both of you: Do either of you believe that there should be a moratorium on all new GSE initiatives unless or until the GSEs, their external auditors, the SEC, and OFHEO agree that the GSEs have resolved their serious problems?

Mr. LOCKHART. From my view, I am not sure a moratorium is needed, but I think that managements need to concentrate on the issues you just mentioned. Developing new products at this point when they are stretched for manpower, new products that would require new systems, new risk management, and everything to go with it, when they are telling us that they cannot really fix the problems for several years just does not make sense to me at this point.

Senator DOLE. Chairman Cox.

Mr. COX. I concur. The focus, of course, of the SEC right now is our ongoing investigation of individuals and organizations who have contributed to the problems we have already uncovered with the respect to the question you and I were just discussing about getting them current in their registration reporting obligations under the Exchange Act. It would be awfully nice to have these restatements accomplished, to get them current, to give shareholders the comfort that they are meeting the listing standards of the New York Stock Exchange and to do first things first.

Senator DOLE. Thank you, Mr. Chairman. I think my time has expired.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS CARPER

Senator CARPER. Thanks, Mr. Chairman. I apologize for not being able to be here to hear your statements. Gentlemen, we thank you for joining us today. We have just concluded our markup of the Chemical Security bill that Chairman Cox and I were talking about and reported it out unanimously, if you can believe that.

Mr. COX. Congratulations.

Senator CARPER. One of my disappointments as a Member of this Committee is that we were unable to pass something out with bipartisan support with respect to GSE regulation. The bill that is now languishing before the Senate is one that I hope we can come back to, take it up, and find common ground amongst ourselves. And I believe your testimony and that which will follow will be helpful toward that end.

Senator Dole has asked you a question that I was going to ask, but I want to follow up a little bit with respect to registration with

the SEC. And I just wanted to ask you, Chairman Cox, if you will, to just further explain the costs to the GSEs for compliance and what effect, if any, that might have on the GSEs' ability to comply with their mission.

Mr. COX. It has been asserted by some that there would be material incremental costs. I cannot tell you today that I believe that to be true, but I think it is appropriate for Congress to weigh the costs and benefits, and the SEC, and our professional staff, including our economists, would be very happy to cooperate with you in that endeavor.

Senator CARPER. Thanks.

Mr. Lockhart, if I could direct a question to you: you may have already been asked this question. If you have, I apologize. I am going to ask it again.

When you look at the changes that have been made at Fannie Mae, and we will just stick with Fannie Mae, but if you look at the changes that have been made there over the last year, would you handicap those which you find favor in and those which you find still fall a bit short of what is needed?

Mr. LOCKHART. I would say they have made progress, but it is disappointingly slow, and I would say the same thing about Freddie Mac. The Chairman of Freddie Mac was quoted this week saying the company is materially different than Fannie Mae. If you read the report we are putting out today, these two companies are still very far away from really being where they should be. And I think that an important part of their mission is they are supposed to be these world class companies that they claim to be to fulfill this mission of affordable housing, and they are not there yet, not even close.

Senator CARPER. The two issues, as I am sure you already discussed it, that kept us apart when we reported a bill out of Committee were the provisions dealing with affordable housing and the issues that relate to the portfolio, what can be in the portfolio, the size of the portfolio, the growth of the portfolio.

Would you just, in layman's terms, both of you, just explain—Chairman Cox, you are really good at this, as I have noted before, just in layman's terms, what concerns should we bring to our final negotiations, which hopefully will get us a resolution and able to move a bill? With respect to the portfolio, what especially should we focus on trying to address?

Mr. COX. Well, both with respect to the affordable housing piece and the limitations on the portfolio, I think it is slightly outside or at least slightly tangential to our main focus at the Commission. What we would like to see, and I would hope that we can keep our eye on this ball, too, is that Fannie would become a normal, in this sense, private issuer of securities to the public that reports under the Exchange Act requirements.

And, if that were accomplished, and if, in consequence, it met the NYSE local listing standards, then, I think it would be a much more salutary discipline on Fannie by the markets based on genuine information. The next order of concern at the SEC, as Senator Sarbanes has mentioned several times, is internal controls. I know this is an issue to Director Lockhart as well, so focus on both the way that Fannie and the GSEs are devoted to their missions and

on the way the regulator has an opportunity to discipline that. I think it is of vital importance.

Senator CARPER. Mr. Lockhart, can you just briefly respond to my question?

Mr. LOCKHART. I think some of the key issues are the systemic risk that we were talking about with Senator Reed and the operational risk inherent in those portfolios, not only from the investments they are making but from the derivatives that help support those portfolios. That has to be a major concern.

We also, in limiting the portfolios, have to look at what is in the portfolios. And to the extent that they are taking more risk, we are going to have to look very hard at that as well. It is the size that is a systemic risk issue, as well as the operational market and credit risk issues in those portfolios.

Senator CARPER. My time has expired. Thanks very much.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. I apologize for having to leave and just catching the tail end of Mr. Lockhart's comment.

I think you may have covered the issue that I want to talk about. Assuming that we get the kind of world class regulator that we are hoping for as the result of legislation, would you feel comfortable with the regulator having the authority to deal with the portfolio issue rather than having Congress mandate any aspect of it?

Mr. LOCKHART. It would be very helpful for Congress to give us guidance, and that is what the Senate bill does, gives some guidance to the regulator. The regulator does need flexibility. I think there are two ways to go about this, and we may have to look at both. One is guidance on portfolio limits, and the other is risk-based capital and minimum capital requirements. As I said earlier, I believe we have to look seriously at risk-based capital rules and the minimum capital rules, because I am not sure that these companies are as well capitalized as they should be going forward.

Senator BENNETT. Well, I am a little reluctant about the Congressional guidance. Guidance is a very vague word. And I think there are two aspects to this, and give me your reaction. One is the safety and soundness of Fannie Mae and Freddie Mac. The other is the systemic risk arising from their laying off the risk through hedges and derivatives. I think the regulator has to look at both. As I understand it, the House bill is almost exclusively the safety and soundness of Fannie and Freddie; is that correct?

Mr. LOCKHART. It is almost exclusively, although they do ask us to do a study, and they mention systemic risk as one of the things we are supposed to be looking at.

Senator BENNETT. OK, if we write it into the law, the standards that might apply in 2006 could turn out in the fast-changing financial services world to be inappropriate as early as 2009 or 2010. Guidance is one thing; specificity is another. Do you have any views as to where the guidance ought to be that would give the regulator the maximum flexibility to respond if there were changes in the derivatives market that we cannot conceive of now but that could have significant bearing on the way the portfolio is managed?

Mr. LOCKHART. Guidance can be part of legislation, as it is in the Senate bill. Certainly, there needs to be that flexibility going for-

ward. We do not want to have to come back to Congress every year to get a fix. I agree with you entirely there.

Senator BENNETT. That is my concern.

Mr. LOCKHART. And one of my concerns when I was at PBGC, for example, you do not get a chance to have major legislation every year in this country.

Senator BENNETT. Yes.

Mr. LOCKHART. At PBGC, I fought 3 or 4 years. Senator Dole remembers this well as my boss: and we finally got legislation, but it did not go far enough. One of the important things we want to do here is to make sure that we go far enough at this point but also give the regulator the powers to make changes.

Senator BENNETT. We are having this hearing as if the bill were still before us, and of course, it is not. The bill has passed out of Committee. So these are just discussions that would inform the debate on the floor.

Let me ask one question just for my own information. You spoke of tremendous earnings being restructured, the earnings restatement. Are there any earnings that will be put into future quarters that were brought into previous quarters in an effort to make the earnings look good when, in fact, they should have been delayed to some future time?

Mr. LOCKHART. I am not sure about that, because we have not gotten all the details. There were some financial transactions that did move earnings out to the future, and I assume they will be restated. We may have actually passed that time by now.

Senator BENNETT. Yes.

Mr. LOCKHART. Basically, I would assume that there will be some ups and downs, yes.

Senator BENNETT. That is a question probably I ought to ask Mr. Mudd.

Mr. LOCKHART. Right.

Senator BENNETT. Because if, in fact, there are substantial earnings yet to come in future quarters, that might explain why the stock market has not reacted as strongly. If all of the money was completely lost and would never, ever be seen again, that is one thing, but if some of it is going to be seen future down——

Mr. LOCKHART. You can ask that of CEO Mudd. But I think the issue is, when they correct the accounting, that those transactions will disappear, basically, because they were not GAAP-compliant, and when they make them GAAP-compliant, they will put the earnings back where they are supposed to be.

Senator BENNETT. Yes, but the thing I am trying to find out is were there earnings? If they were improperly allocated or improperly apportioned, obviously, that is not GAAP-compliant, and obviously, that falls under the——

Mr. LOCKHART. As I understand it, that $11 billion restatement is a net number.

Senator BENNETT. Is a net number; OK, that is what I was trying to find out.

Mr. LOCKHART. And the future earnings will be depending on what they do in the future, basically.

Senator BENNETT. Yes, OK.

Mr. LOCKHART. Because they are going to be keeping their books by GAAP and, now, they have lost most of their hedge accounting, so we will see a relatively volatile set of earnings in these companies.

Senator BENNETT. I see; but that is the point I had not had before: the $11 billion is a net number.

Mr. LOCKHART. That is my understanding, yes, Senator.

Senator BENNETT. I see.

OK; thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and thank you, witnesses.

I have some real concerns here. Obviously, there have been some misdeeds at Fannie and Freddie. I think a lot of people are being opportunistic, taking those and then throwing out the baby with the bath water, saying let us dramatically restructure Fannie Mae and Freddie Mac when that is not what is called for as a result of what has happened here. First, I want to ask you, Mr. Lockhart: the new administration at Fannie and Freddie have taken some real reforms, including the $400 million settlement. Do you think what they have done is good, and do you think it is adequate?

Mr. LOCKHART. The steps they are taking have been good, but they are not adequate yet. As I said before, it is going to take several years to be SEC-compliant and certainly to meet our——

Senator SCHUMER. But what more should they be doing now? It will take years, but that is because of what happened in the past. What more should the new management at Fannie and Freddie be doing that they are not doing now, or at Fannie, anyway, that they are not doing now?

Mr. LOCKHART. They need to continue to work on internal controls, risk management, accounting systems, recruiting people, and reviewing the people that they have. There is a whole series of actions that we have set out in the agreement.

Senator SCHUMER. But are they not in the process of doing all of those?

Mr. LOCKHART. They are in the process of doing it.

Senator SCHUMER. Do you think they are doing it too slowly?

Mr. LOCKHART. They are doing it slowly. Whether it is too slowly, I am not sure, because of the resources available.

Senator SCHUMER. OK, I am a little concerned, also, at the independence of you and the regulator. There seems to be this coordinated effort to go after Fannie and Freddie. On the same day that Treasury announces it is going to try to do what cannot be accomplished legislatively, Secretary Jackson announces HUD's intention to initiate a review of Fannie and Freddie's holdings. Have you had conversations with the administration, with the Treasury, the White House, or the Federal Reserve, about the Senate GSE bill?

Mr. LOCKHART. I have had conversations, obviously, when they were looking at appointing me to the job.

Senator SCHUMER. And what did you say? Did you say you supported it?

Mr. LOCKHART. I said at that point, I did not know enough to say I supported it, but I certainly support the principles of a stronger regulator.

Senator SCHUMER. Well, that, we agree with, but let us go to that issue of, you know, the problems that are here, the accounting problems and others, I do not think you are going to have any dispute. But then, there is, again, the idea to dismantle or greatly diminish Fannie and Freddie at a time when we are having a tougher time for middle class people to find housing. So I want to ask you about systemic risk, which is a different issue.

Mr. LOCKHART. Can I just say about dismantling——

Senator SCHUMER. Yes.

Mr. LOCKHART. Because I would not have taken this job if it was a dismantling job. To me, it is a rebuilding job, and that is what needs to be done.

Senator SCHUMER. Well, do you not think that if you greatly limit portfolios, if you put in pretty strong portfolio limits, it will greatly limit what Fannie and Freddie can do in the future compared to what they do now?

Mr. LOCKHART. It will change what they do, but I do not think it is going to greatly limit them because as I said earlier, they do continue to have the power to securitize mortgages. They package them up and sell them to the marketplace. In fact, that is their bigger business. And really, what happens is they are either going to issue securitized mortgages or debt and buy mortgages. And to the investor, they can make the choice of which they want, and at the moment——

Senator SCHUMER. Let me ask you this: have you had specific conversations with Treasury, White House, Federal Reserve about systemic risk?

Mr. LOCKHART. I have had conversations again about systemic risk prior to my appointment with now Fed Governor——

Senator SCHUMER. How did you define to them, how do you define today what systemic risk is, and do you think Fannie and Freddie in their present status contribute or possibly create systemic risk?

Mr. LOCKHART. I do believe that they create systemic risk. OFHEO put out a report three or 4 years ago that gave some scenarios of how that could be created.

Senator SCHUMER. How do you define it?

Mr. LOCKHART. I define systemic risk as actions by these companies that they could cause a major problem in the economy.

Senator SCHUMER. OK, it says here, page 21 of the report to Congress, based on OFHEO's examination activities to date, it is the overall conclusion of OFHEO that Fannie Mae has strong asset quality and prudential credit risk management policies. Do you agree with that?

Mr. LOCKHART. Yes.

Senator SCHUMER. So how is the systemic risk—let me just ask——

Mr. LOCKHART. They have market and credit risk capabilities that are reasonably strong. They do need to be improved in several areas. Their operational risk is not acceptable at this point.

Senator SCHUMER. Their——

Mr. LOCKHART. Operational risk management.

Senator SCHUMER. Let me ask you this: basically, the systemic risk argument says something terrible can happen, and they have so much that you better be careful. How is it different than the systemic risk that any private institution has, CitiGroup, I do not know, some of the others which are immense as well? Is there any difference?

Mr. LOCKHART. There is some difference, because first of all, this is a very concentrated risk. Citigroup is a very diversified financial institution. This is all concentrated, really, in one market. And they have a tremendous market share, 40 percent.

Senator SCHUMER. Is it not stable market than many of the other markets the financial institutions are in?

Mr. LOCKHART. Housing goes up and down. Interest rates go up and down, and they are two of the real drivers here. As I was saying earlier, you are going to see these companies have a lot more volatility in the future——

Senator SCHUMER. But generally the——

Mr. LOCKHART. It is not totally stable.

Senator SCHUMER. But generally, the market there is regarded as one of the more stable risks by investment grade, by interest rates, by everything else.

Mr. LOCKHART. If you are referring to the credit quality of the borrowers and the asset coverage——

Senator SCHUMER. Yes.

Mr. LOCKHART [continuing]. ——that is more stable than some of the other investments. But one of the things that has happened in this market from time to time is they have done transactions that create risk.

Senator SCHUMER. And so could a private institution.

Mr. LOCKHART. Private institutions have, yes.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

Let me back up a moment for the benefit of those who might have missed part of the hearing. But when we talk about misdeeds, we are really talking about accounting fraud, is that not, Mr. Cox, your testimony, that what we had here was accounting fraud?

Mr. COX. That is certainly the basis for what the SEC charged Fannie with.

Senator MARTINEZ. Now, and the magnitude of the misdeeds which are accounting fraud was $11 billion. That is the magnitude of the restatement, correct?

Mr. COX. That is, I believe, the lower bound of the estimate. We do not know yet what the real number will be.

Senator MARTINEZ. But that will be the bottom of it? It could be higher?

Mr. COX. That is right.

Senator MARTINEZ. Which puts it at about the same level as WorldCom if we were to compare.

Now, also, we have talked about new management. Mr. Lockhart, I want to ask you about that, because it really is of great concern to me about where we are on that issue. In fact, the CEO is not new to Fannie Mae, correct?

Mr. LOCKHART. That is correct.

Senator MARTINEZ. One of the concerns that I have is whether, in fact, the manipulation of the numbers, the manipulation of earnings which is part of what this accounting fraud is about triggered certain bonuses to members of an elite group of executives, correct?

Mr. LOCKHART. That is correct.

Senator MARTINEZ. My understanding from your report is that Mr. Mudd, the current CEO, benefited to the tune of $13 million to $14 million in these bonuses.

Mr. LOCKHART. Yes, he did. I think it was actually $15 million.

Senator MARTINEZ. $15 million?

Mr. LOCKHART. $15 million out of $26 million.

Senator MARTINEZ. His compensation over a 5-year period was $26 million, of which $15 million of those were triggered precisely by the very earnings that were tilted through accounting fraud in part to stabilize the earnings and in part to benefit the executives with these outlandish bonuses.

Mr. LOCKHART. To me, it is not just accounting fraud. This is mismanagement of the company. And I am not referring necessarily to the present management, but I am talking about the management during this period. It is more than just accounting fraud. They underinvested in systems; they tried to do a series of activities to weaken the agency, as you know, and so, it is much more than just accounting fraud in my mind.

Senator MARTINEZ. When we talk about your recommendations or the actions you have suggested, and I know Chairman Cox, perhaps you cannot comment on this, but I am anxious to know whether, in fact, there will be an opportunity for a recovery to the investors of these bonuses which may have been as a result of accounting fraud, and if it is not appropriate to answer at this time, I would be happy to wait until another point to hear the answer.

Mr. COX. Well, I think I can state in the very abstract that disgorgement is always a remedy that is available. Since we are in the midst of an investigation right now, I cannot fast forward to what might be the result.

Senator MARTINEZ. Do you have an estimate, Chairman Cox, of the loss to shareholders created by the accounting fraud that is documented in the OFHEO report?

Mr. COX. Well, certainly, there is a market measure. On the basis of the change in share price—the share price was over $75 a share. Now, it is below $49 as of about June 7, I think, the last figure I have in my head.

Chairman SHELBY. How many billions of dollars roughly, just calculate—

Mr. LOCKHART. It is about a billion shares, so that is about $25 billion, $25 billion to $30 billion.

Chairman SHELBY. $25 billion.

Senator MARTINEZ. So that is about $25 billion in magnitude in terms of what it represents to the investors, and this is to folks who just, in good faith, believing the numbers, believing the reports, bought the stock. Now, you know, we went back and forth here on risk, and my understanding of the systemic risk that this company undertakes, one of the things that makes them different

from a private company is the fact that they have this implicit guarantee from the Federal Government.

Mr. LOCKHART. That is correct; they do have the implicit guarantee, and that is one of the reasons that these companies are still standing. As I said earlier, they would have probably lost their credit rating if they were a normal company. And that has been very helpful to keep supporting the housing market, which we all agree is an extremely important mission of these companies.

Senator MARTINEZ. Which is, at the end of the day, what they are chartered to do, support the housing market and to try to help first-time homebuyers and, you know, bring affordable housing to the marketplace. There are other parts of OFHEO's and HUD's analysis, more HUD analysis of these GSEs which would suggest that they trail, they lag behind the market in terms of providing assistance or mortgage assistance to low and moderate income homeowners, first time home buyers. Are you familiar with that as well?

Mr. LOCKHART. I have heard that, but I have not gotten into the details.

Senator MARTINEZ. You ought to take a look. It is there.

Mr. LOCKHART. I will.

Senator MARTINEZ. Mr. Chairman, my time has expired. Thank you very much.

Chairman SHELBY. We have two votes on the floor. We have one now in the second warning. We are going to take about a 20-minute recess. So the Committee is in recess.

[Recess.]

Chairman SHELBY. The Committee will come back to order.

Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Gentlemen, I very much appreciate you indulging our Committee and in particular giving me an opportunity to get back, and thank you. I know Chairman Cox is well aware of these kinds of procedures, votes and all that go with it, so thank you very much, and I do not have a great number of questions, and the ones that I do, in the interests of time, Mr. Chairman, I will submit for the record, but I do appreciate the opportunity to ask a couple of questions.

Mr. Lockhart, I apologize also, since I had to go manage one of the amendments on the floor, and I may be covering ground here that others have asked. So if that is the case, just tell me, and we will move on to something else. Thank you. Mr. Lockhart, given the level of fraud and mismanagement outlined in your recent OFHEO report on Fannie and previous report on Freddie, how concerned is OFHEO about the ability of the GSEs, Fannie and Freddie, to manage the $1.5 trillion portfolios they have?

Mr. LOCKHART. OFHEO is concerned about the management of both GSEs. The internal controls are not there. Risk management is not there. Accounting systems are not there. We did put a freeze on Fannie Mae for that very reason and are not allowing them to grow their portfolios from year-end levels. We are in discussions with Freddie Mac at the moment on that same issue.

Senator HAGEL. Obviously, if we can pass new regulation reform legislation which would give OFHEO additional authority, additional resources, I assume that would be significantly important, in

fact, to address the concern that you have, the authority. And if you could just develop that in a brief way, how critical is that authority? And by the way, you know where the two bills are, the bill that we passed out of this Committee plus what the House has done. If you do not think that authority is sufficient, I would like to hear that as well.

Mr. LOCKHART. Both bills go a long way to where we need to get to on the safety and soundness issue. There is just no doubt about it: we need more authority and a whole series of things that the bills do cover. In particular, capital authority, receivership authority, and we need more budget flexibility. On the issue of portfolio limits, the Senate bill does give better guidance of where they want to be, and that is helpful.

And there may be pieces in both bills; I believe the House bill has better language on disgorgement, for instance. Basically, legislation is what we need. We need to strengthen this agency. We need to be a much stronger safety and soundness regulator.

Senator HAGEL. Thank you. As you know, the OFHEO report states, and I will quote from the report, quote, by deliberately and intentionally manipulating accounting to hit earnings targets, Fannie's senior management maximized the bonuses and other executive compensation that they received at the expense of the shareholders. That, end of quote, comes from your report.

Can you tell the Committee, were any members of the Fannie Board aware of this accounting manipulation? Or how many were at least aware generally, or how many knew anything about it? How many tangentially had some sense of what was going on?

Mr. LOCKHART. I am not sure that we were able to show that any Board member really knew, and that is the fault of the Board, because their job is to be informed of what is going on in the company, and they were too passive. I say any Board member; obviously, the Chairman of the Board, Raines, was aware, and the other management members of the Board were aware. I am talking about the outside Board members.

Senator HAGEL. And what are we going to do to address that? Because we all understand that that is a primary, certainly a basic fiduciary responsibility of Boards of Directors. Do we need new authorities? Do we need a new Board? Do we need new management? What do we do?

Mr. LOCKHART. In part of our various settlement agreements, we put in a whole series of rules for the Board, and they are starting to make some of those changes. One of the things we did was to separate the CEO and the Chairman job. We are strengthening the Board committees. They have, I think, four or five new Board members and a new member of one of the key committees, the new chair of the Audit Committee, which we really applaud.

So they are making progress, and you will hear from Chairman Ashley later, and he will tell you that they are making progress in the Board. I believe they are, but they may have to go farther. As you know, we have asked the Board to look at the Board members and the management team that are still in place to see if there need to be any additional changes.

Senator HAGEL. How many members of management are still at Fannie who benefited from these bonuses and executive compensation during the period of your investigation?

Mr. LOCKHART. I cannot give you an exact number, but I would guess it is probably over 10 still.

Senator HAGEL. Still there at Fannie Mae, OK.

Mr. LOCKHART. Right.

Senator HAGEL. OK, regarding the lobbying efforts that we have heard a great deal about, which your report focuses on with some detail; in fact, again, I will just quote something very quickly, and then I am going to ask you a question about it from your report: Fannie Mae lobbyists worked to ensure that the agency, OFHEO, was poorly funded and used longstanding relationships with Congressional staff to interfere with OFHEO's special examination of Fannie Mae, end of quote.

The Fannie Mae lobbying effort to generate the HUD Inspector General's fourth investigation of OFHEO and all the other pieces that you addressed, did you direct your attention to, or do you know who, in fact, directed Fannie Mae lobbyists in this regard, members of management there at Fannie Mae?

Mr. LOCKHART. The lobbyists reported to very senior managers, and as I understand it, they were certainly in contact with the chief executive officer. This was a longstanding tradition at the company, as we have already heard several times today. They were extremely active in lobbying Congress and spent an awful lot of money at it.

Senator HAGEL. So does that then imply, or are you then saying it was directed out of the CEO's office? My question would then be was that Mr. Raines? What role did Mr. Mudd have in this, who, of course, is now the CEO but at the time was the chief operating officer. So what did the investigation develop in the way of who was direction——

Mr. LOCKHART. This is an area I have not paid as much attention to. One of the things that we did in our consent decree was we told them to relook at this whole group and do a study of how it is being organized. Mr. Donilon, who sat over this group, as I understand it, was the corporate secretary, and he was in contact with the senior management and Chairman Raines, on what was going on. This whole organization was extremely active at trying to prevent OFHEO from doing its job. And that is the unfortunate truth.

Senator HAGEL. Well, that is a rather significant statement that you have just made, because you have, starting with Mr. Mudd, who is still there, who is managing, as the CEO, this organization, so if, in fact, he was involved in doing what you had just stated the institution, the enterprise as a whole, that is a pretty disturbing point.

I intend to ask Mr. Mudd, when he is up here in a few minutes, what role he played, but you, being the director of the regulatory agency that made this examination and came up with this report, I would ask that this Committee then be informed, as you have noted, further developing more information and a report on this.

Mr. LOCKHART. We will. I can tell you that he has made some significant changes in this group. Maybe more need to be made, but

they are certainly a lot less active than they were, and he has promised me that they will continue to be that way.

Senator HAGEL. Well, and I appreciate that, but again, I will ask him the question, because if he was party to directing efforts, significant multimillion dollar efforts to undermine the institution's regulator, which we found out from your report they were doing, but, if it is that great, they, and I think this Committee and I certainly would like to know who, especially because they all benefited rather significantly from undermining the interest of the American people and the American taxpayer by their conduct and behavior and mismanagement.

As the Chairman of the SEC noted in a more private setting and as was brought out in this hearing this morning, there would be probably some indictments in a private corporation. There may be indictments yet. But in the interests of time, Mr. Chairman, I very much appreciate both what you and Chairman Cox are doing at your agencies. They are important, you know that, at an important time, and I appreciate again your generous efforts to accommodate my schedule. Thank you.

Mr. Chairman, thank you.

Chairman SHELBY. Gentlemen, we appreciate your appearance today and your contribution to good corporate governance and to the GSEs.

Mr. COX. Thank you, Mr. Chairman.

Mr. LOCKHART. Thank you, Mr. Chairman.

Chairman SHELBY. We are going to call up our second panel now: Mr. Daniel Mudd, President and Chief Executive Officer of Fannie Mae, and Mr. Stephen Ashley, Chairman of the Board of Directors of Fannie Mae.

Mr. Mudd, Mr. Ashley, your written testimony will be made part of the hearing record of the Banking Committee. We will first call on you, Mr. Mudd, for any opening statement you want to make.

Mr. MUDD. Yes, sir, if I might, Mr. Chairman, defer to my Chairman, Mr. Ashley, to open and follow him briefly.

Chairman SHELBY. That is OK. If you want to do that, that is OK with us.

Mr. Ashley, then.

STATEMENT OF STEPHEN B. ASHLEY, CHAIRMAN OF THE BOARD OF DIRECTORS, FANNIE MAE

Mr. ASHLEY. Thank you, Mr. Chairman, Senator Sarbanes, Members of the Committee, my name is Steve Ashley. I have been in the mortgage business for over 40 years, and the last time I had the privilege of testifying before this Committee was when I served as President of the Mortgage Bankers Association of America.

Eighteen months ago, I was asked to become the independent chairman of the Fannie Mae Board of Directors, and I appreciate the opportunity to appear before the Committee today. The Fannie Mae of 1998 to 2004 portrayed in the final OFHEO report of its special examination is a far different company than was portrayed to the Fannie Mae Board by departed management, our former external auditor, and annual regular examination reports. I would like to comment briefly on the Board and the company's response

to the OFHEO special examination of Fannie Mae and the changes we have made and are continuing to make to address the problems identified.

On September 20, 2004, when we received OFHEO's interim report, we acted immediately to examine and respond to its findings. Within a week of receiving the report, we reached an agreement on a process to resolve the issues raised by the report. We pledged to work cooperatively with OFHEO, and we began supervising the work of fixing the company. Also in September 2004, the Special Review Committee of the Board initiated an independent review of the issues raised in the OFHEO report and other matters relating to the company's accounting, governance, structure, and internal controls.

To conduct the review, the Committee engaged former Senator Warren Rudman and his law firm of Paul Weiss, which retained the services of a forensic accounting firm. The Board directed that the work of Paul Weiss be transparent to OFHEO, the SEC, and the Department of Justice during the entire period of review.

In October 2004, the Board established an ongoing Compliance Committee. And by the end of 2004, working with OFHEO, we had taken action to replace our outside auditor, launch our restatement, and replace our chief executive officer and chief financial officer. Since September 27, 2004, the full Board has met 43 times; Board committees have met 146 times.

Since January 1, 2005, I have met directly with the director or acting director of OFHEO 17 times. As independent chairman of Fannie Mae, I typically spend 2 to 3 days a week at the company providing direct oversight. Working with OFHEO, we also agreed to take steps to further strengthen the company's corporate governance. Let me describe some of these and other changes the Board has made.

We separated the roles of the chief executive officer and the chairman of the Board. Five of the 12 nonmanagement members are new since 2004, and the newest member, Dennis Beresford, is a former chairman of the Financial Accounting Standards Board and is serving as chairman of the Audit Committee. All five of the new Board members are independent of management. We eliminated two seats held by management, retaining just one, to increase the proportion of independent Board members. In addition, in accordance with our corporate policy and OFHEO's corporate governance rules on length of service, another Board member, Ann Korologos, will be leaving the Board effective July 31. As lead director and chairman of the Governance Committee in 2004, she felt it was her duty to remain on the Board an extra 2 years to see us through the investigative phase, which is now complete.

To ensure accountability and the timely flow of information, we established reporting lines to the Board for the positions of chief audit executive, chief compliance and ethics officer, and chief risk officer. During this period, the Board exercised one of its paramount functions: to select and review the performance of the CEO of the company. We made a change in leadership at Fannie Mae when we appointed Dan Mudd as interim CEO on December 21, 2004.

We directed Mr. Mudd to begin working with the Board and with OFHEO to implement our regulatory agreements, carry out other necessary and appropriate changes to the company, and put Fannie Mae on the right track. More specifically, we made clear that his duties included the following: restoring the company's capital; restating Fannie Mae's financial results; building a new management team, particularly in the areas of finance, accounting, and audit; rebuilding relationships with regulators, customers, and stakeholders; garnering credibility with the investment community; boosting the company's investments in our financial systems and internal controls; and rebuilding the company's culture.

In June 2005, the Board selected Dan Mudd as permanent president and CEO of Fannie Mae, after consultation with OFHEO and a very thorough review by Senator Rudman. As interim CEO, Mr. Mudd demonstrated an ability to lead a large financial institution through a major and challenging transition, including the ability to reach out and rebuild confidence with our regulators, Congress, and others. He demonstrated his capacity for the job by doing the job.

On May 23 of this year, the company took a big step forward when we reached settlements with the Securities and Exchange Commission and OFHEO. The settlement with OFHEO addresses the recommendations found in the OFHEO final report. The Board is committed to ensuring full and total compliance with these agreements.

Mr. Chairman, I can report to this Committee that there is a strong determination on the part of the Board, management, and the employees for Fannie Mae to grow into a different company than it was from 1998 to 2004, and that changes have been made up, down, and across the organization. At the same time, the Board understands that Fannie Mae still has much more to do, and working with our regulators and with this Committee and the counterpart committees in the House, we intend to hold ourselves and the management team accountable for the changes to be made.

I welcome this chance to report to you, and I am happy to answer any questions.

Chairman SHELBY. Mr. Mudd, do you have a statement?

STATEMENT OF DANIEL H. MUDD,
PRESIDENT AND CEO,
FANNIE MAE

Mr. MUDD. Yes, thank you, Mr. Chairman, Senator Sarbanes, and Members of the Committee. I appreciate this opportunity to appear before you today, and to update you on the progress that we have made at Fannie Mae since I began in the role as chief executive officer in December 2004.

It is clear from the Rudman report, from the OFHEO report, that Fannie Mae got a lot of things wrong from 1998 to 2004. Bad decisions about accounting and many other matters let a lot of people down and in so doing broke a public trust. We have learned some painful lessons about getting things right and about hubris and about humility, and we have made changes. We are making progress. But we have much more to do, and I am determined to do it.

We began with a plan to fix the company on December 31, 2004, the day that I was appointed as interim CEO. We set out to restore our capital, restate our prior financial statements, rebuild our relationships with our regulators, partners, stakeholders, and Members of Congress to manage our business and recenter our company on serving the families who need affordable housing, armor-plate our financial controls, and finally, to fix our corporate culture, which the OFHEO report makes clear led to a lot of our problems.

I have heard your comments today, and I have heard, certainly, many more comments in private. The days of the arrogant, defiant, "my way" Fannie Mae had to end. We have begun to build a Fannie Mae that listens better, that welcomes accountability, that works with our regulators and with Congress and serves the market by putting our mission to serve housing first.

Let me describe briefly some of the tangible steps we have taken starting with the people. First, we have established a new senior management team to provide the leadership, the talent, and the ethical standards worthy of our role and our mission. We have a new chief financial officer; we have a new comptroller; a new chief audit executive; a new chief of accounting policy; a new general counsel; a new chief risk officer; and a new head of corporate strategy.

Second, in cooperation and consultation with OFHEO, we are fundamentally reorganizing the company to ensure that strong checks and balances are in place. We have separated the portfolio business from the chief financial officer's responsibility. We have reorganized the finance function and brought in entirely new leadership from outside the company. We are reorganizing and strengthening internal audit.

We have also replaced our outside auditor with Deloitte and Touche, which is conducting a comprehensive re-audit of the entire company. They have over 300 auditors onsite as I speak at Fannie Mae. We are making further key organizational changes, which include establishing a new and separate compliance and ethics organization. We have written and publicly pledged ourselves to a standard of ethical, honest, and transparent conduct. We have established a new chief risk organization with an independent and comprehensive view of all of the risks the company is taking. We have disbanded the so-called Law and Policy Division.

Third, we have restored and maintained our capital adequacy. We now have roughly $39 billion of capital in reserve, and our ratio of capital to assets is higher than it has ever been in our history.

Fourth, we are paying people to do the job, not to hit targets. We have adopted a new executive compensation structure with broad performance goals.

Fifth, we are making steady progress on completing our financial restatement, which will be done by the end of 2006. We have already completed the restatement of significant portions of our balance sheet and developed the systems to support and control our business. We are in the process of putting in place systems and controls to ensure that we are GAAP and Sarbanes-Oxley compliant. There is absolutely no routine or process or control anywhere in the company that is beyond the scope of overhaul and improvement to the highest standard. We can get this done. Our over-

arching goal is to get it done once, to get it done right, and to make sure the investments occur so that this will never happen again.

Mr. Chairman, I would also like to reiterate a commitment that I made to the Committee last April, which is that Fannie Mae will work cooperatively with Congress to put legislation for GSE regulation in place. We do want a bill. In particular, we continue to support legislation to create a strong, well funded regulator that would oversee both the safety and soundness and the mission attainment of the enterprises.

With respect to how we engage Congress, that is part of the new Fannie Mae as well. I hope that you have seen a new tone and manner of quiet, fact-based engagement from us. Where we disagree, I hope we disagree respectfully. You have my pledge to do all I can to move this process forward.

Mr. Chairman, from the day I was appointed to lead Fannie Mae, we have been moving forward aggressively to identify the problems identified by OFHEO. The question may be: Why is this worth doing? The reason this company exists is because of our housing and liquidity mission, with the goal of putting people into homes. In the last 18 months, we have purchased or guaranteed more than 4 million home loans. We have helped to create 136,000 more minority homeowners and serve 600,000 moderate- and low-income families. We have helped provide financing to build, rehab, or finance over half a million units of affordable rental housing. Nearly two-thirds of our overall business serves one or more of our HUD affordable housing goals. And, we are investing literally billions of dollars in the Gulf Coast region to help finance and rebuild the homes and communities there.

During the past 18 months, we attracted more than $21 billion of overseas investment to provide liquidity here in the U.S. housing market. And, this year, we are providing roughly half a trillion dollars to finance homes for 3 million Americans, 25 percent of them African-American, Hispanic, and/or first-time homebuyers; all of them Americans looking to own or rent a home and become part of a community.

I know that you are counting on us to fulfill our mission and to help us serve this growing Nation and its growing housing needs. I believe that is what makes this worth doing. Mr. Chairman, the company is changing and will continue to change thanks to these lessons we have been given to learn. My obligation and my pledge to you in Congress is to move forward and to get this right, to build a Fannie Mae that is truly able to serve affordable housing in America.

Thank you for the opportunity, and we look forward to your questions.

Chairman SHELBY. Mr. Ashley, you and Mr. Mudd both referred to the Rudman Report. How much did that cost Fannie Mae to get Mr. Rudman's law firm to do that inside?

Mr. ASHLEY. Mr. Chairman, the last number that I heard on the total investigation, which would include the costs of not only the work of the Paul Weiss team but also the forensic accounting team that was engaged plus search firms that were engaged——

Chairman SHELBY. Sure.

Mr. ASHLEY [continuing]. ——was around $70 million.

Chairman SHELBY. $70 million. And, of course, there was a lot of difference between the Rudman report and the OFHEO/SEC report.

Mr. Mudd, you wanted to work with us on legislation. When are you going to start, because I see no evidence of that myself in the last 6 months?

Mr. MUDD. Senator, I hope we have been——

Chairman SHELBY. And I would like for you to.

Mr. MUDD. Yes, sir, we are available any time, 24 by 7.

Chairman SHELBY. We are, too, but we have not seen any evidence of any change in tone that you talked about.

Mr. MUDD. Well, Senator, I apologize for that, and if there is anything that we have missed, I would be happy to address it. Believe me, I believe it is in the interest of the enterprises to have a strong, credible, well funded regulator that has all the normal bank-like authorities that any regulator that we are familiar with would have, and if there is anything I can do to support that, I will.

Chairman SHELBY. We are going to give you an opportunity, and we hope you do it.

Mr. Mudd, in your testimony, you suggested that Fannie Mae got a lot of things wrong from 1998 to 2004: bad decisions about accounting and many other matters that let a lot of people down and in so doing broke a public trust. Those are your words. Mr. Mudd, by bad decisions about accounting, I am assuming you are referring to the accounting fraud that Fannie Mae was found to have engaged in and was penalized by the SEC. Is that what you are talking about?

Mr. MUDD. That is part of it, Senator. I think the routines, the processes, the controls, the investments that we had in place were clearly inadequate. But I actually paint the picture a little bit broader than that and talked in my statement about the culture, about the focus, and other areas that we are focusing on to try to get it right.

Chairman SHELBY. You are not suggesting, though, here in your words, I hope, that they were just bad decisions, not fraud, are they? The SEC has said that you all were guilty of fraud. You agreed to pay $400 million. You are not trying to minimize that here at this hearing, are you?

Mr. MUDD. No, sir, we have reached a settlement on all those matters with the SEC.

Chairman SHELBY. I am just using your words.

Mr. MUDD. And we certainly do not disagree——

Chairman SHELBY. I am just quoting your own words.

Would you agree that fraud is a little more serious and much more significant than just, quote, your words, letting people down and breaking the public trust?

Mr. MUDD. Yes, sir, I would.

Chairman SHELBY. Mr. Ashley, where does the buck stop? For example, the SEC and OFHEO said, quote, that an extensive financial fraud—extensive financial fraud—was committed at Fannie Mae. But, of course, corporations are abstract entities that cannot commit fraud in a sense; somebody does it. Mr. Mudd and Mr. Ashley, both: Who are the individuals primarily responsible for the ex-

tensive financial fraud at Fannie Mae that SEC Chairman Cox talked about?

Mr. MUDD. Senator, there are processes in place going on right now at the SEC and at the Department of Justice.

Chairman SHELBY. Sure.

Mr. MUDD. We are cooperating with all those. That is ultimately their determination, but I assure you——

Chairman SHELBY. We know it is under investigation still.

Mr. MUDD. Yes, sir.

Chairman SHELBY. Mr. Ashley, during the time addressed in the special exam that we have talked about here, it would be helpful for the Committee and for the record if you could give us a basic understanding of how the Board, which you have been a member of before you were chairman, operated in providing oversight of Fannie Mae's management; for example, perhaps you can outline for the Committee what typically happened at a Board meeting, such as did the Board typically hear presentations from Fannie Mae staff other than senior management? Did the Board ask questions—you were a member of the Board—regarding these briefings? And were Board members encouraged to raise agenda items for the next Board meeting? Was the company's relationship with OFHEO ever discussed at these meetings?

Mr. ASHLEY. Mr. Chairman, typically, Fannie Mae's Board meetings, which would be calendared seven to eight times a year, now eight times a year, would be 2 day meetings, with 1 day devoted to committee meetings. The Board functioned through the traditional governance committee meetings: Audit; Compensation; Governance, Assets, and Liability, which is now renamed the Risk Policy Committee; Housing and Community Development.

Those meetings would contain presentations and discussion from management within the jurisdiction that those committees had. During the Board meeting, the committee chairs would report on the work of the committees. In addition, there would be regular reports from various members of management—not simply the CEO—including, perhaps, in-depth items, such as financial reports and so forth.

Chairman SHELBY. Mr. Mudd, the House testimony on initial findings, on October 6, 2004, Mr. Raines and Mr. Howard gave testimony to the House Subcommittee denying OFHEO's preliminary report on Fannie's accounting and culture. Did you disagree with any of their comments? Did any of their comments strike you as untrue, inappropriate, misleading? Did you communicate, if so, your views to anyone either inside the company, to the Board, or anyone else?

Mr. MUDD. Senator, I——

Chairman SHELBY. Did those comments bother you? You were inside the company then.

Mr. MUDD. Yes, sir; I was not involved in the preparation for those comments, nor did I hear them at the time. Clearly——

Chairman SHELBY. But you are aware of what was said.

Mr. MUDD. Yes, sir.

Chairman SHELBY. You have reviewed it since.

Mr. MUDD. And as I have worked through——

Chairman SHELBY. Do those comments bother you?

Mr. MUDD. Yes, sir, they do.

Chairman SHELBY. Did they bother you when you first learned about them?

Mr. MUDD. Senator, I would say that they bothered me. As I came into this job and had to work through what the actual facts were and had to get to the bottom of where the financial issues were, the sheer scope of the financial accounting matters that we had to address and the depth of the issues in terms of our Financial Accounting Department, our Controls Department, and the environment there over that period of time when I saw what the issues looked like on the ground, did increasingly bother me.

Chairman SHELBY. Mr. Mudd, there are people who question you are the appropriate person to head Fannie Mae. We know you are the CEO, and you were elected by the Board. Given your role in senior management at the time in question we are talking about here, as chief operating officer of the company during this time, how is it that you were not aware of any of these practices?

Did you ever question how it was possible that the company that you were the chief operating officer of then could achieve such stable earnings in light of the business model being pursued and the accounting required under FAS 133? And if so, to whom did you raise these questions if you were troubled by them, and what efforts did you undertake to further examine them and to remedy them.

Mr. MUDD. Yes, sir. It is a tough question, Senator.

Chairman SHELBY. That is part of our job up here. You know that.

Mr. MUDD. It is one that I think about an awful lot myself. And since the time I came into the interim job here, I have been——

Chairman SHELBY. No, I am referring back to when you were the chief operating officer.

Mr. MUDD. Yes, sir, yes, sir, and I just wanted to give you a bit of background.

Chairman SHELBY. OK.

Mr. MUDD. Five years worth of my e-mails, my appointments, my letters, the meetings that I had, and the documents that I saw were fully reviewed by both OFHEO transparently and in the Rudman report.

Chairman SHELBY. That is not what I am asking you. When you were the chief operating officer, were you aware of what was going on in the company? You should have been.

Mr. MUDD. Yes, sir.

Chairman SHELBY. And if so, I am not asking you about your emails and OFHEO now; I am asking you specifically, were you aware of this if you were—and you were the chief operating officer before you were promoted to be the CEO.

Mr. MUDD. Yes, sir. In my role as chief operating officer, my responsibilities were principally dealing with the customers and dealing with the systems technology. I would say that as the issues unfolded, there was no moment where someone was hit by lightning on the road to Damascus and saw everything for what it was as a piece. Rather, I would answer your question by saying——

Chairman SHELBY. If you were not hit by lightning on the road to Damascus, was the sky lit up for you where you could see a little better?

Mr. MUDD. I would say the clouds gathered, the lightning began to strike, and things got worse from there, Senator.

Chairman SHELBY. Did it take a lightning strike to wake you up, and you were the chief operating officer?

Mr. MUDD. No, sir, it took understanding a train of events and a series of issues that enabled the Board, management, those that are there now, independent auditors, and OFHEO who you heard from earlier today, to take all of those pieces and put them together to understand the full scope of where things had been. I would not suggest to you that any one single piece of information or evidence brought all that to light at once.

Chairman SHELBY. Were you ever deeply troubled where you could not sleep at night? I mean, you are the chief operating officer, and you have got to, in the culture, know what is going on. And if you did not know what is going on, you know, what is your job?

Mr. MUDD. Yes, Senator, my job was focused on the customers and on the technology systems. I was not responsible for financial accounting. I was not responsible for the mortgage portfolio. I was not responsible for internal audit, and I was as shocked as anyone in the company or anyone in Congress or anyone in the market when these issues were uncovered and came to light.

Chairman SHELBY. Senator Sarbanes, thanks for your indulgence.

Senator SARBANES. Thanks, Mr. Chairman.

Mr. Ashley, in light of these questions, I would be interested in understanding the Board process that led to Mr. Mudd now assuming the CEO position at Fannie Mae.

Mr. ASHLEY. Yes, sir, I am happy to go through that. Clearly, in December 2004, when it became obvious to the Board that Messrs. Raines and Howard could no longer lead the company, we reached out to Dan to serve as an interim CEO and President.

Soon thereafter, right around the first of 2005, the Board created a Search Committee, which was chaired by Director Ann Korologos, engaged in a very thorough, nationwide, and very competitive search. The search was pretty well discussed in the media with some names at the time. That search went through until the latter part of April 2005. During this time period, I was serving as independent chair, nonmanagement chair, and Mr. Mudd was serving as an interim CEO.

Senator SARBANES. When did you become the interim chair?

Mr. ASHLEY. I never served as an interim chair, Senator. I was elected chair of the Board on the 21st or 22nd of December 2004, as a nonexecutive chair, I think is the terminology.

Senator SARBANES. Previously, had the chair and the executive been combined in one position?

Mr. ASHLEY. Yes, sir, that is correct.

As we moved through the spring of 2005, it became clear that Mr. Mudd was doing a very good job, and indeed, I would say an excellent job of moving the company from where it had been, starting the process of change in culture that was necessary, developing a new organization for the company, weeding through people, ter-

minating people, and then, most importantly, starting the process of recruiting individuals of excellent talent and new to the company beginning first in the finance area and the comptroller's area.

When it became clear that Mr. Mudd was going to be a finalist—not necessarily the finalist, and, indeed, at that point in time, he was not the finalist—I approached Senator Rudman as well and had discussions with the then-director of OFHEO as to was there anything in their knowledge, their background, that would suggest that the Board should not move forward considering Mr. Mudd as a finalist. Senator Rudman's team spent approximately 2 to 3 weeks doing very in-depth reviews. I believe that these were the things that Mr. Mudd was referencing earlier in his response to Chairman Shelby's question. They did a very detailed review of every aspect of Mr. Mudd's work at the company, seeking to discover whether he was in any way implicated in any of the wrongdoing that had been identified in the interim report of examination from OFHEO that was given to us in September 2004.

Senator Rudman's investigation was thorough. He met with the Search Committee and then later with the full Board discussing the results of his investigation, and at that point in time, the Board felt that there was no reason why Mr. Mudd should not be considered for the CEO position, and indeed, we did elect him as President and CEO, I believe, in 2005.

Senator SARBANES. Now, if I heard you correctly, you said just a moment or two ago not only that you took this up with Rudman but with the Director of OFHEO.

Mr. ASHLEY. I had discussions with the director of OFHEO, yes, Senator.

Senator SARBANES. Is that Mr. Falcon at the time?

Mr. ASHLEY. That would have been Mr. Falcon.

Senator SARBANES. And what was the gist of those discussions?

Mr. ASHLEY. My recollection, Senator, is that I had one discussion where I outlined that Mr. Mudd was going to be considered as one of two finalists. I asked whether there was any reason that we should not consider him, because if there was, I wanted to be sure that that was clear to the committee and the Board at that time. He asked for some time to do whatever work he needed to do and to check, I am sure, with colleagues at OFHEO.

At a subsequent point in time, I cannot remember exactly what the time lapse was, we had another discussion, and he indicated that, in his view, there was no reason that we could not go further considering Mr. Mudd for this position.

Senator SARBANES. Has the Board reexamined this question in light of the recent OFHEO report?

Mr. ASHLEY. Senator, we have, and when the OFHEO report was ready several weeks ago, approximately a week before it was released, it was made available to a small group under confidentiality for fact checking. At that time, it became certainly obvious to those reading the report that Mr. Mudd was named a number of times in this report, and therefore, I felt that the Board had to examine those findings and discuss them thoroughly.

The Board did so. We asked Senator Rudman to read the report, to come back to us and to address questions as to whether there were new findings, whether there were new material findings, and

whether there was anything on what we had previously known of Dan's involvement that had turned up in the Rudman Report that was new or different or that would cause Senator Rudman or his team to change their opinion and their recommendation to the Board that they had made in the spring of 2005.

He reported that there was not any reason that they would change their opinion on that. The Board read the report, examined every notation that was made in the report regarding Mr. Mudd, discussed it. We met in an executive session. We had the benefit of counsel. The Board did not take action until after full discussion with and without Senator Rudman and in all cases without Mr. Mudd. We discussed further, and then, on the morning that the OFHEO report was released, we expressed our confidence in Mr. Mudd to continue in service as CEO of Fannie Mae.

Senator SARBANES. Well, my time is up. If I could just put one more question, the report of OFHEO on the special examination of Freddie Mac, not Fannie Mae now, but Freddie Mac, which came earlier, said the corporate culture fostered by that tone at the top resulted in intense and sometimes improper efforts by the enterprise to manage its reported earnings. And they go on then to discuss this.

Now, it sounds very familiar as we look through the report of the special examination of Fannie Mae. I would put it to both of you: did you read the Freddie Mac report, and did it register on you in terms of, well, you know, what are we doing here, here being at Fannie Mae? Did anyone pick up on that, both in management and on the Board? So I put the question to both of you.

Mr. ASHLEY. Senator, I will respond.

Senator SARBANES. And I apologize to my colleagues.

Chairman SHELBY. That is all right.

Mr. ASHLEY. I will respond as to the involvement of the Board and the discussion of the Board around the Freddie Mac report.

Certainly, the Board was well aware of the issues that had surfaced at Freddie Mac. They had been publicized; copies of the executive summary of the report were distributed to the Board. I believe that there was discussion in the Audit Committee with KPMG, Fannie Mae's auditors. There was clearly discussion at several Board meetings during that early time period about whether Fannie Mae had any of these problems. Questions were addressed to CEO Raines and CFO Howard in the Board meetings.

The Board received complete and full assurance from both executives every time the issue was discussed that Fannie Mae did not have those problems. At the same time, the Audit Committee was receiving assurances from KPMG that that indeed was the case.

Mr. MUDD. Nothing to add, Senator, other than that the same level of reading and review was done across management, but, broadly, the process and the conclusions followed Mr. Ashley's comments.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman.

I would like to follow up on the questions that I asked the Director of OFHEO with respect to the earnings. I am not quite clear, and I am not quite sure of his answer. It is my understanding that

one of the problems was that the earnings were placed in the wrong quarter or the wrong fiscal reporting period in an effort to make that period look better and that in the restructuring and restating, the earnings are not going to go away. They are going to reappear in another financial reporting period.

Now, he said that the $11 billion figure was a net figure and that they all went away. So I am confused: the newspaper reports led me to believe one thing; his statement was the other. Given the degree of analysis that you have made of all of those earnings, I think you probably are in a better position to answer that question. I do not know if you heard my question to the Director, but could you respond to that area, either one of you?

Mr. MUDD. I would be happy to, Senator.

The restatement goes back for the years 2001 to 2004, and those amounts of earnings recognition will be retimed. Approximately $11 billion, actually somewhat less than that, was overstated in the prior periods. Those periods will be corrected, and, by and large, there will be some fine-tuning differences with respect to where some securities are priced in the market and so forth; but, as a broad theme, your assumption in your question is correct: those amounts will then flow back into future periods as the restatement is completed.

Senator BENNETT. Do you have a dollar figure on what the net really is, then? Because from what you have just said, the net was not the $11 billion that he was quoting.

Mr. MUDD. No, sir. To use parallel terms, the gross amount potentially under restatement is slightly under $11 billion, but exactly how those specific amounts apply from period to period is exactly what we are determining——

Senator BENNETT. I see.

Mr. MUDD [continuing]. ——in the process of the restatement, and I will not be able to give you that answer until the restatement is completed this year.

Senator BENNETT. What would you be surprised if it were more than? That is an unfair question, but just ball park. Do you think that half of the $11 billion will show up in some future statements?

Chairman SHELBY. This is pure speculation, is it not, Mr. Mudd?

Mr. MUDD. Senator, I would not—we have made significant progress on the restatement. We have now been through all of the policies that apply, understand where there were misapplications of GAAP, and understand how each of those securities were priced during that period under the relevant accounting rules that were applied. We have rewritten the systems to do that. We have completed the process of restating significant portions of that, and small adjustments aside, the overwhelming proportion of the balance of that flows back in.

Senator BENNETT. OK, so it would be more than half of the $11 billion will flow back in at some future time?

Mr. MUDD. Yes, sir, well more than half.

Senator BENNETT. All right, thank you. I appreciate that clarification.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Thank you.

Let me stay on that point for a moment, because I am a little lost in this conversation. I take a pretty simple view of all this, Mr. Mudd. Dishonesty is dishonesty, whether it is $11 billion or $5 billion. Do you agree with that, Mr. Mudd?

Mr. MUDD. Yes, sir, I do.

Senator HAGEL. So intentional, fraudulent behavior, intentionally misstating anything is irrelevant, it seems to me, as to the numbers. Do you agree with that or not agree with that?

Mr. MUDD. I do agree with that, Senator.

Senator HAGEL. Let us just get the record straight on this: whether it is $11 billion or $6 billion, if fraud was committed, it was committed, and that is what the OFHEO report says.

Chairman SHELBY. That is also what the SEC said.

Senator BENNETT. And I am not suggesting that there is not fraud. I am just wanting to know the financial condition of the company, and the financial condition of the company is affected enormously.

Senator HAGEL. Senator, the financial condition of any company reflects on the culture and the management and the honesty and the ethics of a company.

Senator BENNETT. I agree.

Chairman SHELBY. That is right.

Senator MARTINEZ. The fact is they do not know the financial condition of the company and have not known it for years.

Senator HAGEL. That is the other element. We do not know. And what is interesting, Senator, is we keep finding out more and more.

Now let me, if I might, get on to some other questions. Thank you for clearing that up, Mr. Mudd. I will have some questions for you in a moment.

Mr. Chairman, how long have you been on the Board?

Mr. ASHLEY. Senator, I have been on the Board since May 1995.

Senator HAGEL. You have been there quite awhile.

Mr. ASHLEY. It seems like a long time, yes, Senator.

Senator HAGEL. So you have seen an awful lot.

Mr. ASHLEY. I have seen a lot in the last 2 years that I never expected to see, Senator.

Senator HAGEL. Well, apparently, there was a lot you did not see.

Mr. ASHLEY. Senator, I share your concern and your sense of, I think, righteous outrage on this.

Senator HAGEL. Oh, do not give me any righteous outrage, Mr. Ashley. This is not about righteous outrage. It is about fraudulent conduct in the interests of those who were managing an institution with their own greed and their own self interest. So this is not righteous outrage. That is for the confessional or for your spiritual advisor, Mr. Ashley.

You have a fiduciary responsibility, and I think you failed, and the entire Board failed, and according to the reports, it is pretty clear that you failed. Now, can you sit there and tell this Committee that you knew nothing about what was going on? Because to hear the two of you talk or somebody else, the chief operating officer said he was not aware of much of this, which we will get to the chief operating officer in a moment.

But you seem that you do not know anything about what happened, what was developing, the lobbying, the money, the com-

pensation. You have seen the compensation here that Mr. Mudd received as well as Mr. Raines and a number of others here. Now, you are a man of great experience and depth in this business. Was that strange to you at all that was going on, no questions asked?

Mr. ASHLEY. Senator, I have worked 40 years in the mortgage banking business, and I have had a great passion for this business. And I cannot express to you the deep disappointment and anger that I as a member of the Board, and I know this is shared by my colleagues on the Board, feel at this moment in time when a company and a management and people that we put our trust in was broken, not just broken, but shattered.

And the fact that the Board trusted Frank Raines and Tim Howard I think is reasonable for any Board to be able to trust their management. To the point that they do not trust that management, they should remove that management.

Senator HAGEL. What about Mr. Mudd? Was Mr. Mudd exempt from this? He was chief operating officer according to the records here.

Mr. ASHLEY. Senator, I think in my response, I believe, to Senator Sarbanes' question, I explained the process that the Board went through to affirm the trust and to be sure that we could place trust in Mr. Mudd going forward in his leadership, in his judgment, in his management decisions.

Senator HAGEL. Well, I do not know how much you read of any of these reports. The question was asked by Mr. Sarbanes a few minutes ago. But let me just respond to this comment about Mr. Mudd. This comes from the OFHEO report. There are a number of indications of Mr. Mudd's awareness of what was going on. This one, in particular, is an e-mail that Mr. Mudd wrote in 2003. It is in the OFHEO report; quote, Mr. Mudd says in the e-mail, I spoke to a Treasury Department official. He had agreed to talk to the SEC on what to do if OFHEO was not falling in line. Already, another Treasury official had already bent his ear about OFHEO obstructionism—OFHEO obstructionism—promised me he would check in to see where things were and would call the SEC when we needed to, end of quote.

Now, this is an e-mail from Mr. Mudd, chief operating officer, who does not know anything about what is going on, nor do you as a member of the Board. So how do you respond to that when you say that you were offended by Mr. Raines and Howard and others who just bamboozled you all, because you really did not know what was going on?

Mr. ASHLEY. Senator, the e-mail in question, I believe, and Mr. Mudd can explain it in more detail, I believe related to a call that was made at the time the company was seeking SEC registration.

Senator HAGEL. What do you know about the lobbying efforts? Did Mr. Mudd have anything to do with that? Did you have anything to do with that? How many Board members had contracts who did lobbying on behalf of the institution? Do you know anything about those things?

Mr. ASHLEY. Senator, I was——

Senator HAGEL. Does Mr. Mudd know anything about those things?

Mr. ASHLEY. I think Mr. Mudd can respond to that. I was not engaged in lobbying activities on behalf of the company. There is one Board member, which is, this is public information, where there is a contract, a consulting contract with his firm.

Senator HAGEL. Is this still active?

Mr. ASHLEY. It is still active.

Senator HAGEL. You do not find any conflict with that?

Mr. ASHLEY. He is not an independent director under the Board's independence guidelines. The director in question provides good counsel to the Board and to myself.

Senator HAGEL. So you have a Board member who is compensated, I understand; is that right?

Mr. ASHLEY. He is.

Senator HAGEL. Then, in addition to that compensation, that Board member is hired as a lobbyist.

Mr. ASHLEY. His firm is hired as a lobbying consultant to the company.

Senator HAGEL. And you find nothing irregular about that?

Mr. ASHLEY. Certainly in the standards of independence and governance going forward, I would choose to see every director, other than the single management director, be completely independent in every way, shape, and form, and this Board is moving in that direction.

Senator HAGEL. What is the answer? I did not get your answer, the answer to my question.

Mr. ASHLEY. Senator——

Senator HAGEL. Do you find nothing inappropriate about that relationship?

Mr. ASHLEY. Senator, the relationship has been handled appropriately during the period that that conflict has existed since that director has been on the Board. My further response is that the rules of governance that I see for this company going forward would dictate that every nonmanagement director be independent in the fullest sense of the word.

Senator HAGEL. So what is your answer? You find nothing inappropriate with that kind of——

Mr. ASHLEY. The relationship has been handled appropriately, Senator.

Senator HAGEL. So it is not inappropriate to have a member of the Board who is not part of management but have his firm being paid contractually for lobbying efforts and also a member of the Board of Directors.

Mr. ASHLEY. The issue, really, for governance is whether that matter has been appropriately disclosed and the relationship is handled appropriately. I feel very strongly that there should be no conflicts with Board members going forward.

Senator HAGEL. You obviously do not think that is a conflict.

Mr. ASHLEY. Senator, at the present time, this relationship is handled within the rules of the road.

Senator HAGEL. That is not my question, and you know it, Mr. Ashley. Mr. Ashley, part of the problem we have, you have, your institution has, is because you do not give straight answers. This is not complicated. Now, I do not know, maybe because you have

been on the Board too long, but I do just find it astounding that neither of you really know anything that has been going on.

Now, Mr. Mudd, I am going to read something here: Regulator says Mudd knew of misdeeds. This is from the May 24, 2006, story by Terence O'Hara, Washington Post, and it says this: Fannie Mae Chief Executive Daniel H. Mudd was aware as early as the fall of 2003 of serious allegations of accounting misdeeds and failed to pass key information on to the company's Board of Directors according to Fannie Mae's Federal regulator. In the first detailed account of Mudd's involvement in the management lapses at the mortgage giant, the Office of Federal Housing Enterprise Oversight also cited an instance in which Mudd asked a Treasury Department official to intervene on the company's behalf to rein in OFHEO during its examination of Fannie Mae's accounting practices, and I am sure you have read it, and it goes further.

Would you care to respond to that, Mr. Mudd?

Mr. MUDD. I would.

Senator HAGEL. Inaccurate, wrong, right?

Mr. MUDD. Well, Senator, the Post itself corrected that headline the next day.

Senator HAGEL. I am not talking about the headline. I am talking about what it says, the story. Was the story inaccurate?

Mr. MUDD. Senator, I was never aware of any misdeed, any mischaracterization, any intentional violation of accounting rules. Looking back, are there things that I regret? Absolutely.

Senator HAGEL. Did you benefit from the $6.46 obsession? Do you know what I am talking about? Let me refresh your memory. In the same year—this is from the OFHEO report—Sampath Rajappa, Fannie's senior vice president for operations, risk, and head of internal audit told Fannie's Internal Audit Group, quote, you must be obsessed, he says to all of you, on $6.46. After all, thanks to Frank, we all have a lot of money riding on it. Remember, now, Frank has given us an opportunity to earn not just our salaries, benefits, raises, employee stock purchase programs, but substantially over that if we make $6.46, end of quote.

You recall, I suspect, maybe you do not; maybe you do not know this either. The final EPS number for 2003 was $7.29, which triggered the bonuses. Now, I am sure you remember bonuses and what everybody got. Now, this report from OFHEO cites a number of you which did pretty well. And according to this, if this is accurate, your compensation over that period, those last 4 years that we had the investigation, 2000 through 2003, is $26,306,057; is that accurate?

Mr. MUDD. Yes, as reported, Senator.

Senator HAGEL. So you did not really have much to win or lose, obviously, on any of the fraudulent behavior that was going on in the $6.46 memo. Let me ask, did you ever see that memo?

Mr. MUDD. Senator, there is no place for fraud or cheating or misuse of rules in any company that I work for. And as I stated in the prior question, I did not participate in any of that; I was not aware of that; I did not go to any meeting where any of that was discussed. I think the attitude is inappropriate. I think it is inappropriate in the company. I think it is inappropriate for an inde-

pendent auditor to be saying anything at all like that. I reject those comments. We have changed it entirely.

Senator HAGEL. Did you see the memo?

Mr. MUDD. I did not see the memo, and I did not hear the speech.

Senator HAGEL. Well, this memo had wide circulation.

Mr. MUDD. I am sorry; I have seen it since the time. I thought you meant in the actual timeframe it was given; I am sorry.

Senator HAGEL. No, I am asking in the actual timeframe.

Mr. MUDD. No, I did not.

Senator HAGEL. You did not see it. You must be one of the only senior members who did not see it, because according to the OFHEO report, this was given wide circulation, and the chief operating officer did not see it.

Mr. MUDD. Sir, if you are referring to Mr. Rajappa's comments about the $6.46——

Senator HAGEL. Yes, sir.

Mr. MUDD [continuing]. ——my understanding, having read through the report, is that that was a speech that he gave to his own group of employees, and not being one, I was not present there.

Senator HAGEL. Just for the record, Mr. Raines, in that period, it was actually a 6-year period, he comes out according to the compensation, according to the OFHEO report, over $90 million; Mr. Howard comes out with $30 million; Jamie Gorelick, for a 4-year period, comes out with about $27 million. You are right in there at over $26 million. We have Mr. Levin at $26 million. So there was a rather significant interest, I suspect, by senior management to reflect those numbers that Frank stated for everyone. And the Board knew nothing about any of this; is that correct, Mr. Ashley?

Mr. ASHLEY. Did the Board know anything about Mr. Rajappa's——

Senator HAGEL. No, no, no. The Board knew nothing about any of this $6.46, not necessarily the memo but the target numbers that would incentivize management to get all the stock deals, the bonuses, the compensation? The Board knew nothing about any of that?

Mr. ASHLEY. The Board would have received periodic updates on earnings throughout the year and forecasted earnings to year end as any Board, I would hope, would receive that information.

Senator HAGEL. Thank you.

Mr. Chairman, I have gone over my time.

Chairman SHELBY. No, you take time, whatever you need.

Senator HAGEL. Thank you. Another point here.

[Laughter.]

Senator HAGEL. This is a memo as well from independent analysis, and it quotes you, Mr. Mudd, and this is a memo that evidently, you wrote in 2000. And it says this: we also need to continue to focus on our 2003 challenge. We still have a gap of nearly $375 million in pre-tax income. I know that the numbers in our third quarter forecasts around our big bets are still being refined as we iron out the issues and that those revenue numbers may well change. It is clear that these new products may not be sufficient to get us to our $6.46 goal. And we as a company must be looking

hard at what it will take to make it. Now, this is from OFHEO report, page 78.

According to the report, you wrote that memo.

Mr. MUDD. Yes, sir, that is true. All companies that I am familiar with in my time have budgets, have targets for revenues and expenses, have compensation plans that have targets in them. Part of my responsibilities were to manage those P&Ls for the businesses that I was running. And I spent most of my time doing that. Never at any point would I sanction any departure from the rules in order to hit those targets. Part of managing a business is to try to attain the results that the organization has set out for, and that was my focus, Senator.

Senator HAGEL. I see. I find it interesting, because in response to the Rajappa memo, you acted like you were not aware of this target number, this $6.46.

Mr. MUDD. No, sir; no, sir, if I conveyed that impression, I did not mean it. I was aware of the target number.

Senator HAGEL. But you were not aware of the memo.

Mr. MUDD. I was not aware of Mr. Rajappa's speech to his own group of employees.

Senator HAGEL. All right; well, I think I received what I needed.

Let me ask one last question. I have a number of questions for the record that we will submit. Mr. Mudd, in light of all of this, I mean, first, are you thinking seriously about giving any of this money to charity that you received through all the fraudulent misrepresentations? And am astounded that you would even stay with this institution. Have you thought about resigning?

Mr. MUDD. Senator, I have thought about an awful lot of things. I did not like the old Fannie Mae any more than I understand from your emotions and words about this that you liked the old Fannie Mae. And I thought about leaving the old Fannie Mae a lot of times, and I did not, because I am not a quitter. I stayed around. If the standard is now, if you quit, you get off scot free, and if you stay around, and you try to fix it, you are a bad guy, Senator, I cannot do anything about that standard.

Senator HAGEL. What is your compensation now?

Mr. MUDD. I am focused on getting the problems fixed and getting this organization to where it needs to be.

Senator HAGEL. Thank you. What is your compensation now?

Mr. MUDD. I think the last year, the number was around $8 million, including salary, bonus, and long-term.

Senator HAGEL. What about this year?

Mr. MUDD. I do not know what the targets are. I would be happy to send——

Senator HAGEL. Well, $8 million is not a bad number. I can see why you would also want to stay around for that incentive. I mean, that is not altogether something that I suspect is not part of your consideration. Mr. Chairman, I appreciate——

Chairman SHELBY. Thank you, Senator.

Senator HAGEL [continuing]. ——the indulgence of the Committee, and I will submit some questions for the record. Thank you very much.

Chairman SHELBY. Thank you.

Senator Carper.

Senator CARPER. Mr. Mudd, Mr. Ashley, I would like to try to refocus the questioning a little bit if I might.

One of my disappointments in serving on this Committee in the last 5 years was our inability to find common ground to develop consensus on how best to regulate GSEs going forward. We had a vote here right along party lines. We sent a bill to the floor which is not going to see, frankly, in my view, the light of day until we can bridge our differences in two critical areas. One of those is affordable housing, and second is the issue of portfolios, what should be in the portfolio, how large should the portfolio be, how quickly can it grow?

I have observed and had an opportunity to discuss with a number of my colleagues on both sides of the aisle here in this committee; we have discussed these two issues, with the real focus on the affordable housing position. Over in the Federal Home Loan Bank, they have an Affordable Housing Program where they are required by law to set aside, I think, 10 percent of their net income into an affordable housing fund. Those numbers go to the States and are divided up, distributed, and mingled with State monies, local monies, nonprofit monies, for profit housing dollars in order to create affordable housing for the residents of probably all 50 States.

I sensed in recent weeks, maybe last couple of months, a growing consensus on this Committee that we should put in the final bill that we take up for debate and hopefully pass in the Senate this year an affordable housing provision. Senator Reed has worked hard on it; I know others have as well.

Would you take just a minute or two, Mr. Mudd, and talk with us to share your counsel and your views on what makes sense with respect to an affordable housing provision; maybe looking at the Home Loan Bank; is the model a good model or a bad one? Looking at the House bill as either a good model or bad bill, and tell us in your own view what we should keep in mind as we attempt to craft our own provision on the floor.

Mr. MUDD. I will do my best, Senator.

I think that the housing goals are an important and an intimate part of what we do, and I support them fully. Over the years, the administration of the housing goals has been on the HUD side, and the safety and soundness administration has been on the OFHEO side. So the counsel, I guess, that I would have on that is that both pieces of legislation, as I understand them, are correct in contemplating a single regulator. I think it is important to have a single regulator, because in one place, you can balance out the safety and soundness goals with the mission goals and see the whole thing of a piece. So I think the regulator having a broad view of everything that goes on in the enterprise is certainly an important thing.

The goal structure that we have right now was originally a set of goals expressed as a percentage of business. There is now a set of subgoals in place that represent a percentage of business for purchase money mortgages, really, first-time homebuyers, principally. And the idea that has been discussed in the course of the legislation is an affordable housing fund.

I think all those are eminently good ideas, and my only encouragement would be that they be considered all of a piece, all of a

piece together so that all of our activities are pointed in the right direction, and it is the direction that Congress and the administrative agencies want us to go in.

Senator CARPER. By the way, the Federal Home Loan Banks, as I recall, under the law, they have a requirement to set aside 10 percent of their net income into an affordable housing fund. I am not sure what the approach is in the House, but I think it is similar to that. In conversations I have had with one of our Republican colleagues, we have talked about establishing an affordable housing fund, and instead of having some percentage of net income, to have a transaction fee that would be related to the magnitude of, I guess, the bonds that are underwritten and securitized.

Any comment on which of those may be more appropriate?

Mr. MUDD. Just a couple of thoughts. As I understand the Home Loan Bank program, as it exists, there are no percentage of business goals. So that is really their one focus in terms of the affordable housing piece of it. So again, if we, per the discussion earlier, considered all of those of a piece, I think that would be a good idea.

Second, the Federal Home Loan Banks have in place the apparatus, really, to dispense those monies in the form of grants. We could do it. We could build out the infrastructure, but my encouragement would be that instead of the focus on grantmaking, *per se,* which is not something we do, that it be focused on the type of activities that the GSEs are already into, which are funding loans and making investments in the areas that need it most.

Senator CARPER. All right, one other question, if I may: The other critical issue that has divided us, I believe, deals with portfolios: what is in a portfolio, how large, how quickly can it grow. And I am not sure that all of us have a very good understanding of the nature of your portfolios, what is included, to what extent the assets in your portfolio help support housing authorities, like our State housing authority in Delaware or municipal housing authorities and those, frankly of other States as well.

Just take a couple of minutes, if you will; give us a primer, just lay out for us the nature of the assets that comprise your portfolio, how those assets maybe relate to your mission, and any concerns that you might want to share with us with regard to limitations that could be imposed on those portfolio, maybe that should or should not in your view.

Mr. MUDD. Yes, sir, it is a great question. I will try to start.

We have two lines of business: a guarantee business, which provides guarantees on mortgage-backed securities held by others and a portfolio business which are investments on our own balance sheet. That portfolio is approximately $722 billion as we speak today.

Contrary to some of the thoughts, there is nothing in that portfolio that is not related to housing or finance or mortgages but for a small component, I think about 7 percent, that is a liquidity fund per an agreement we have with the Treasury Department to ensure that we have nonmortgage liquidity in the event of some dislocation in the mortgage market.

So within the portfolio, what we hold are 50 percent conventional, conforming mortgage-backed securities, the principal business that we are in. We hold 35 percent whole loans, so there are

mortgage loans that, instead of being packaged already into a mortgage-backed security, exist each unto themselves, and about 14 percent municipal securities, sub-prime securities, Alt-A securities, mortgage revenue bonds and so forth. And, we have, in addition to that, a Low-Income Housing Tax Credit portfolio and a fund investment, a set of funds in specific projects in communities all across the United States.

Those are the activities that are really encompassed on the balance sheet of Fannie Mae. They are all housing related. As some of the Senators have indicated, the portfolio is the first business that we were in. That was the business that we were first put in business to pursue. And the idea was that that portfolio would be used to provide liquidity into the secondary market for mortgages, so that there is a steady supply of funds into the mortgage market so that in the event of a dislocation, a Katrina, a 9/11, or those types of things, there is still a steady flow of funds there. That kind of gives some confidence to the mortgage market.

We have this liquidity mission, and we have an affordability mission. My own view, Senator, is that those two things are pretty intimately linked, and they are pretty intimately linked into the overall structure of the mortgage market in the United States. And, I would just add a point, which is that I do not think it should be an unrestricted portfolio, and that is reflected in the sanctions imposed by OFHEO in the course of this settlement agreement, in which they said you have got some issues; hold the portfolio flat; fix the issues, and when we are comfortable with it, you can move again.

Those are normal, bank-like regulatory authorities that exist in a lot of institutions. I am not uncomfortable with that, but I also do not know what the future might bring. And there is a provision in the discussions with OFHEO that if there is one of those dislocations, we would obviously immediately be in touch with OFHEO to make sure we could respond and continue to serve that liquidity mission.

Senator CARPER. Thanks.

Mr. Chairman, thank you for being generous with this time. I just want to say in conclusion, we should be able to work this out, and you are——

Chairman SHELBY. You are talking about the legislation now.

Senator CARPER. Yes, yes, and you are as gifted as any Chairman I have ever worked with. And you have got willing people on this side and I know with my colleagues on the other side. We ought to be able to work this out, and these are the two critical points. And I would just offer whatever help and service that I can be in trying to get us to develop a consensus. I want to do that. I would like to see us have a strong regulator. We need to regulate these folks, and we can certainly do better. And those are the two points that are holding us apart. And we have got to be smart enough to figure out how to find common ground there. I think we can.

Chairman SHELBY. We are also going to need the help of Fannie Mae. Mr. Mudd knows that. And I hope we will get it, but we have not gotten it thus far.

Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

Mr. Ashley, does the Board currently have a Compensation Committee?

Mr. ASHLEY. The Board does have a Compensation Committee, Senator.

Senator MARTINEZ. I am astounded that, given the level of scrutiny under which this company is today—we can talk about the past, but I am talking about today, now, that Mr. Mudd's compensation is, as he revealed a moment ago, $8 million last year, and I do not even know what it will be this year. But is your Compensation Committee comfortable with that level of compensation? And are they still derived from the same types of schemes as was in the past, the way in which compensation was derived?

Mr. ASHLEY. I will answer the second part of your question first. No. Mr. Mudd and all other executive compensation is not derived on the same formulaic basis that it was previously where the bonuses were tied singularly to an achievement of an EPS target. There are multiple factors currently that go into evaluating the bonus levels, which are decided by essentially each committee of the Board that has oversight for that particular function of the organization, and then, those flow into the Compensation Committee for composite review, and ultimately, the entire Board is engaged in the discussion. It is a fulsome process. It is not tied to EPS; certainly today not at all, because we do not have earnings.

Now, to the first part of your question, Senator, the approach that this company, first of all, is chartered, but second must undertake is competitive compensation for those skill sets that we must have in the company. And those come primarily from the financial services sector, so this company is competing with the 20 or so major financial services companies in the country. So competitiveness is one factor. There is a second factor that must be brought in given the charter status that this company has and the mission status, and that is appropriateness.

Senator MARTINEZ. How much is the compensation for the CEO of Freddie?

Mr. ASHLEY. I do not know. We would be glad to supply that for you.

Senator MARTINEZ. I can find it, but you do not know.

Mr. ASHLEY. I do not know.

Senator MARTINEZ. But you believe it to be comparable?

Mr. ASHLEY. I actually believe it to be in excess of Mr. Mudd's. Those comparabilities were examined by the Comp Committee at the beginning of the year when Mr. Mudd's salary was established.

Senator MARTINEZ. What is the Board doing about the compensation that was paid in bonuses as a result of what has now been acknowledged, and I presume you would agree, was through fraudulent accounting practices? Let me clarify that. Would you agree that the accounting precisely were fraudulent in nature as alleged in the report by OFHEO?

Mr. ASHLEY. Senator, that is a very difficult question for me to answer, because there are legal proceedings around this. I, speaking individually, have a great deal of discomfort with what was done. There is a process in place——

Chairman SHELBY. Senator, could you yield just a second?

Senator MARTINEZ. Yes, sir.

Chairman SHELBY. You have great discomfort, and you entered into an agreement to pay a $400 million fine, you, as the Chairman of the Board of Fannie Mae and so forth; excuse me, but that is troubling to this Senator.

Mr. ASHLEY. Senator, I wish I could speak as affirmatively as I feel inside.

Chairman SHELBY. OK.

Mr. ASHLEY. My lawyers are tugging at my coattails.

Chairman SHELBY. OK, the Senator has the time.

Senator MARTINEZ. Given that there is obviously a problem with the prior compensation and the scheme by which it was derived, and whether we would call it fraud, I mean, I can be freer; I can understand the constraints under which you may be testifying, would it be appropriate for the Board to take action to receive or to obtain a payback, a repayment, to ask these folks who obtained these very large bonuses for payback for the benefit of the investors, to help pay the fine, to restore the faith in the company, to restore the trust of the public, because it is a Government-Sponsored Enterprise, because the mission is to provide housing for the least of our people, for all of those reasons?

Mr. ASHLEY. I agree with all of those reasons. Let me tell you the process that the Board has in place. First of all, there is no reward of any form for those who have committed fraud. Let us be very clear on that. The Board is working with the SEC, with the DOJ, with OFHEO, and there are ongoing investigations of the individuals at this point in time, which is one of the constraining factors that I am speaking under here.

The Board will be informed by those investigations, and I have said several times publicly that every option is available to the Board when we are informed by those investigations and in consultation with counsel. And that is a process that must play out. I would like to be able to sit here today and tell you it was concluded and give you finality to it. It is not, but it will be.

Senator MARTINEZ. In terms of your current CEO, Mr. Mudd, and his current role and the appropriateness of his current role, he was the COO, chief operating officer previously. You can say to this Committee that your Board is comfortable that this is the best person to lead Fannie Mae at this point in history, at that point in time, given the prior participation in the company at a time that seemed to have been so troubled in management as well as in other activities?

Mr. ASHLEY. Senator, I can.

Senator MARTINEZ. OK, now, Mr. Mudd, and you and I have talked a number of times, and I appreciate the candor with which you have dealt with me, and I appreciate that greatly. And I do not find this comfortable, because I like you.

One of the things that has come to light is your commentary to Mr. Raines in November of 2004, which states in part, and I only have part of this memo; I hope it is not out of context: the old political reality was that we always win; we took no prisoners; and we face little organized political opposition. We used to, by virtue of our peculiarity, be able to write or have written rules that worked for us. We now operate in a world where we will have to be normal.

That culture, that type of environment, you are the COO, you are being compensated, as has been stated, in very substantial amounts, including bonuses of about $15 million over the period of those several years. And what I would ask is a question that often arises in these types of situations: Mr. Mudd, what did you know about the practices at the company that you were the COO of, and when did you know it?

Mr. MUDD. Thank you, Senator.

I indicated in the earlier question, my knowledge of the issues, the challenges, the problems, the misdeeds unfolded over a period of time, and what I would ask your indulgence to do is, because I think it is responsive to your question, is to give you the context that might not have existed in that memo. Because, in fact, what I was doing then in the prior regime was encouraging the company to change.

Senator MARTINEZ. I will allow you to do that, and I am delighted for you to do it.

Mr. MUDD. Yes, sir.

Senator MARTINEZ. When you talk in this memo, you are talking about we. We always won. We took no prisoners. We faced little organized political opposition. We used to, by virtue of our peculiarity, be able to write or have written rules that worked for us, and we now operate in a world where we will have to be normal.

Mr. MUDD. Yes, sir.

Senator MARTINEZ. You are including yourself as part of that culture. And I understand that perhaps what you were doing here is signaling that there needed to be a change, and you were a change agent, and in that regard, I compliment you. But I also wonder what did you know, and when did you know it? And I will be glad to hear your memo, but I would like an answer to that question: when did you know of what was happening at Fannie Mae that we all today find so troubling?

Mr. MUDD. Senator, I became aware of the problem in its full manifestation the day that you did, the day that the SEC announcement was made. I was shocked and stunned by that. I understood that there were issues in the culture. I understood that there were management issues along the way. I understood that we did not quite have all the skills we needed in all the areas we needed to to keep up with the increasing cycle of new accounting standards that need to be implemented.

But never, never, never, did I have any indication that that would lead to the type of problems that have now come to light. And so, my whole focus now is on getting those fixed. I was never aware of any misdeed, any intentional misapplication of any accounting procedure, any fraud, any cheating; none of those activities. My own focus was on getting things done right.

The sentence immediately after the one that you cite in the memo was: the new reality—because there are approximately 10 or 12 paragraphs that are missing between those two lines that you have quoted—was the new reality is that 4 years of continuous fighting has worn out even our friends. We no longer get the benefit of the doubt. The fight has resulted in relationships that are worse than they were when we started, and the new reality is that legislation can happen without our acquiescence. Finally, all this

action has supported our idea, our brand of affordable homeownership, with a political brand, just as feared. We were lightly regulated for a long time. Now, we have the SEC, OFHEO, other governmental bodies essentially telling us for the areas in their purview how to operate. We will have to, and have started to, forge a new constructive relationship with OFHEO.

That is the type of thing that I was writing back in those days, Senator. I did not always win.

Senator MARTINEZ. When was that memo? November of 2004?

Mr. MUDD. Yes, sir.

Senator MARTINEZ. OK, I would like to have that memo, Mr. Chairman, attached as part of the record. I think it would be helpful for us to have the entirety of that.

Chairman SHELBY. Will you furnish a copy of that for the record?

Mr. MUDD. Yes, I will, sir.

Chairman SHELBY. That will be made part of the hearing record without objection.

Senator MARTINEZ. So what you are saying, basically, is that when you wrote that memo, was that prior to the SEC report?

Mr. MUDD. Yes, it was.

Senator MARTINEZ. So at that point, at some point prior to the SEC report, you had knowledge that all was not well at Disneyland, right?

Mr. MUDD. I had knowledge that we were not—that we did not have the culture that we needed; we did not have the financial skills that we needed; and we needed to get them in place quickly, remembering that——

Senator MARTINEZ. That is prior to the SEC report.

Mr. MUDD. Yes, sir, that was.

Senator MARTINEZ. Let me ask you this: did you know, or did it occur to you that—you were the COO—that the Audit Department was concerned with their own compensation, with EPS as an obvious conflict of interest? I mean, would it not be a little troubling to suggest that the Auditing Department's compensation to the members of the Auditing Department was going to be dependent on the EPS of the company, and what could an Audit Department do to impact the EPS other than cook the books?

Mr. MUDD. Senator, that is deeply troubling to me. I do not think that is the way an audit staff should be compensated or focused, and I have changed that since I took this job. The audit team is——

Senator MARTINEZ. Did you know about that before then? When you were the chief operating officer, did you know that the Auditing Department's compensation was derived from the EPS?

Mr. MUDD. Senator, the compensation of the entire company at that time was derived in some measure off of the ultimate financial results of the company.

Senator MARTINEZ. So you were, as COO, aware that your Audit Department's compensation depended on the EPS of the company.

Mr. MUDD. Yes, that is true. And that was also the understanding that I had in other prior companies that I had worked for.

Senator MARTINEZ. The Audit Department is special, is it not?

Mr. MUDD. Yes, it is.

Senator MARTINEZ. Is it not the arbiter, is that not the one that sets the books is the one that the investors rely upon? I mean, you are a publicly traded company.

Mr. MUDD. It is a very important function. It is a very important check. It is very important for it to be independent and report directly to the Board, as it does now. It is very important that all of its compensation, any of its compensation really be aligned toward telling the truth, not toward being aligned with the result of the company.

Senator MARTINEZ. But you knew of it then, and you did not do anything to seek to change that at that time.

Mr. MUDD. I knew that their compensation was aligned with the rest of the company.

Senator MARTINEZ. Which depended on the EPS.

Mr. MUDD. Ultimately, it did depend on the results of the company, and those results were expressed in EPS, yes, sir.

Senator MARTINEZ. As a member of the Board, sir, did you know that?

Mr. ASHLEY. Senator, the fact that all employees of Fannie Mae shared in one way or another in an EPS target was known to the Board. I would point out that during the 1990s and the early part of the decade of 2000 that this was an accepted and indeed promulgated form of compensation, in addition to base compensation, that most of corporate America, publicly owned corporate America, engaged in in one form or another. The purpose was to align the management of the company with the interests of the shareholders. Fannie Mae——

Senator MARTINEZ. The Audit Department is not part of management.

Mr. ASHLEY. No, I quite agree.

Senator MARTINEZ. That goes well below management, does it not?

Mr. ASHLEY. I quite agree with your point on this.

Senator MARTINEZ. My question is: did the Board know that at the time, and were there any bells that went off? Did you have any concerns about the obvious conflict of interest?

Mr. ASHLEY. I do not recall any discussion in the Board about the Audit Committee compensation. It may have taken place in the Audit Committee, *per se,* which would have been the proper venue for it.

Senator MARTINEZ. Let me just ask one last question, Mr. Chairman.

Chairman SHELBY. You go ahead. It is important.

Senator MARTINEZ. Mr. Mudd, as we go forward, we have a bill pending. Three years ago, some of us were working, I as the HUD Secretary and others of this Committee to get a bill done. You and I have discussed before the fact that your predecessor, Mr. Raines, told me that he would be favorable to that bill. He then proceeded to scuttle it, to come over here and lobby against it and send the very vast array of lobbyists at the disposal of Fannie Mae to do just that. Do you employ as many lobbyists today as you did then? Friendly question; I know the answer.

Mr. MUDD. I am sorry?

Senator MARTINEZ. Is that a friendly question? I know the answer.

Mr. MUDD. The answer would be no, we do not, sir.

Senator MARTINEZ. You have told me that you want a regulatory bill that would help your company; I believe it would help your share price to have a good, strong regulator in place as soon as possible; is that correct?

Mr. MUDD. Yes, sir, I agree with you on that.

Senator MARTINEZ. Why can we not get complete support for our bill, including portfolio limits? I mean, should your portfolio limitations—be obvious that you need them, that you must have them, that the risk is too great, that the taxpayers bear that risk? Can we not persuade you to support the bill currently on the floor so that we can move forward, give you a strong regulator, fulfill the promise that Raines made to me some time ago that he did not fulfill but that I believe is so apparent a need of this company to have a strong regulator in place, even if you have to swallow hard about the portfolio limits? Because maybe the times are such that you have just got to operate differently. Maybe there is a new normal. Maybe you cannot make your own rules. Maybe you cannot set your own standards. Maybe you cannot continue to operate with a weak regulator. Maybe this needs to be part of the new culture and go ahead and endorse this bill and not continue to fight the portfolio limits aspect of this bill, because you still do have friends.

Mr. MUDD. Senator, thank you for the question and the sentiments.

I would like there to be a bill. As far as I know, the discussions have not included a change in our mission, and as I understand it and as I interpret it, our charter is still for us to provide liquidity in the secondary market for mortgages.

There are other companies I am sure that the Committee is familiar with that have many different divisions and many different operations. We only have two lines of business: our guarantee business and our portfolio. And, my own perspective, as much as I enjoy being here today, I have no vote in the process, my own perspective is that it is very important to understand that those two businesses operate together in order for us to perform our mission.

And if, through the legislative process, Congress still wants us to accomplish the same mission, I have got those two tools to do it, and I think it would be much more difficult for me to represent to you that I could do that if I had fewer tools to accomplish it, sir.

Senator MARTINEZ. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel, but then, I have got a few questions after you.

Senator HAGEL. Thank you. I just have a couple of follow-up questions to Senator Martinez's line of questioning on lobbying expenses. If I understood that exchange, Mr. Mudd, in your answer to Senator Martinez as to less lobbyists employed today, is that what you said? What did you say?

Mr. MUDD. Do you want me to elaborate?

Senator HAGEL. I do not want you to elaborate. Say again what you said to Senator Martinez.

Senator MARTINEZ. I believe he said they had fewer lobbyists.

Senator HAGEL. Is that what you said?

Mr. MUDD. Yes, sir.

Senator HAGEL. Well, I have before me information that says, in fact, your lobbying expenses have increased every year. Is that not right or——

Mr. MUDD. Senator, having looked at this, the way that the formula works——

Senator HAGEL. What formula?

Mr. MUDD. There is a formula under which we report our lobbying expenses to Congress and so forth. And what we have done is stopped using outside lobbyists, by and large, to carry any water for us but rather to, in order to pursue the type of constructive engagement on this that I think is most appropriate, have folks in the company who are in management, who are familiar with these issues, visit with Members of Congress or with others in order to explain the very types of questions we are talking about today.

As I understand the way that the formulation works, the amount of time, for example, that anyone would spend doing that is divided across your base of expenses, and that becomes effectively attributable lobbying expense. We are spending less on outsiders carrying any water for us. We are having more folks come up and explain where we are. But that results in the number being larger than it would be otherwise.

Senator HAGEL. But that does not exactly square with your answer to Senator Martinez. According to that formula or whatever formula you use, and I would like for the record to show, and you can get more information on that, as to who is lobbying from your organization and how you are compensating them and how much money, regardless of the formula, then, what you are telling me is that there is more lobbying going on. Or you are paying your people inside more than you were paying outside people.

Mr. MUDD. No, sir.

Senator HAGEL. Why is the number up? Regardless of the formula——

Mr. MUDD. It is expressed as a percentage of our expenses.

Senator HAGEL. I am not talking about percentages. I am talking about raw numbers. 2005 is what I have before me right now: $10,080,000; 2004, $8,790,000; 2003, $8,700,000; 2002, $7,500,000. These are dollar numbers; not percentage numbers, they are dollar numbers. So again, explain to me your answer to Senator Martinez. You are spending more on lobbying according to the reports.

Mr. MUDD. Those numbers, Senator, are expressed as a percentage of time spent against the total expense for lobbying. Therefore, because our expenses have gone up due to the restatement and due to other reasons, the factor against which we are multiplying it to produce that has gone up. The amount of time, the number of firms that are involved in this——

Senator HAGEL. That does not make any sense.

Chairman SHELBY. That is not the question he is asking you.

Senator HAGEL. That is not the question I am asking anyway.

Senator MARTINEZ. How much are you paying for lobbyists? Are you paying more money out for lobbyists? Do you have more lobbyists? Do you have fewer lobbyists?

Senator HAGEL. Obviously, he is paying more.

Senator MARTINEZ. That is part of the culture that we are talking about fixing that your memo—you know, we need to have confidence that this is in fact changing.

Mr. MUDD. In terms of the number of individuals inside the company that are working on that, fewer. In terms of the number of outside firms that are working on that, fewer. In terms of the number of management individuals that have spent time on the Hill talking about these issues, explaining these issues, those are counted in the equation, Senator. That is all.

Senator HAGEL. Go ahead.

Senator MARTINEZ. So you come to the Hill to meet with a Member of Congress.

Mr. MUDD. Yes, sir.

Senator MARTINEZ. Somehow or other, your time allocation to that is made as part of your lobbying expenses.

Mr. MUDD. Yes, sir. That is my understanding.

Senator HAGEL. I would like to see those numbers, and I would like to see those records and how you keep those records, if you will provide all that for these years, these last 4 years for the Committee, and how much out of your salary—your compensation last year was $8 million, you said; is that right? $8 million was what your compensation was last year? Total compensation.

Mr. MUDD. I can get you the exact numbers in terms of reporting.

Senator HAGEL. Well, you used the term $8 million a few minutes ago.

Senator MARTINEZ. W-2.

Senator HAGEL. Well, then, I would like to see how much of that $8 million is allocated to lobbying for you, and I would like to see that breakdown, as you have just said that you have fewer lobbyists, outside lobbyists, more internal people doing the work.

Now, let me ask both of you a question, since you seem not to have good memories on these things. In April of 2004, Fannie ran a very significant series of television ads attacking GSE reform the week before a Senate Banking Committee markup on GSE reform. Now, obviously, each of you were at Fannie in 2004; each of you were there in fairly responsible positions. You just happened to see the ads? Did you know about the ads? How did the lobbying work? You were chief operating officer, Mr. Mudd. What did you know about ads, how much money they were spending, and the content of the ad?

I remember at the hearing, as Chairman Shelby, I suspect, recalls, I was astounded that a GSE, a Government-Sponsored Enterprise, was running television ads against the oversight Committee that chartered it, the Congress. I was astounded by that. Now, what did you know about that?

Mr. MUDD. I had a general awareness that those ads were running, Senator, and when this came on my watch, we have essentially stopped any advertising like that, because I agree with you.

Chairman SHELBY. So this was advertising, you call it, not lobbying.

Senator HAGEL. Yes.

Chairman SHELBY. Although, the end result is lobbying. Is that how you attribute it in your accounting? Was it attributed to advertising by Fannie Mae rather than lobbying?

Mr. MUDD. I am sorry, Senator, I was just trying to respond to Senator Hagel's question.

Chairman SHELBY. Well let me ask you, if Senator Hagel will permit me.

Senator HAGEL. Yes, Mr. Chairman.

Chairman SHELBY. All these TV ads that you were running that he is referring to, did you deem that advertising rather than part of your lobbying shop, although the end result, it was lobbying against our legislation?

Mr. MUDD. I can go back and look at——

Chairman SHELBY. We would be interested in that.

Mr. MUDD [continuing]. ——what the reporting was at that time to understand it. It was up through a different division, so I was not familiar with it at the time.

Chairman SHELBY. It is a lot of money, though.

Mr. MUDD. But I would be happy to provide for the Senators how that was characterized.

Chairman SHELBY. If you would do that for the record along with the others.

Thank you, Senator Hagel.

Senator HAGEL. Yes, Mr. Chairman, thank you.

Did the Board have any idea of what was going on? Or the overall numbers, since you have been on the Board, for example, Mr. Ashley, the numbers I have, Fannie has spent a lot of money on lobbying. Did the Board know anything about expenditures? I mean, we are getting into tens of millions of dollars is where we have been since 1998, about $61 million, according to the report spent on lobbying. Did the Board know about this?

Mr. ASHLEY. The details of the lobbying expenses were not known to the Board, Senator.

Senator HAGEL. Not even the numbers? You had no idea that $60 million was being spent over that period of time?

Mr. ASHLEY. I was unaware of these numbers until I became nonexecutive chair.

Senator HAGEL. Do you think the Audit Committee of the Board knew anything about it?

Mr. ASHLEY. If they did, I am not aware, Senator. I do not recall this ever being reported out as a numerical number to the Board.

Senator HAGEL. I will have additional questions for the record. Thank you.

Chairman SHELBY. Mr. Ashley, you were a member of the Board of Directors of Fannie Mae from 1995; is that correct?

Mr. ASHLEY. That is correct, Mr. Chairman.

Chairman SHELBY. And you are still a member, and you are Chairman of the Board now.

Mr. ASHLEY. That is correct, Mr. Chairman.

Chairman SHELBY. There is no break in that service for 11 years?

Mr. ASHLEY. There is not, Mr. Chairman.

Chairman SHELBY. Did you have an Audit Committee at Fannie Mae?

Mr. ASHLEY. Yes, sir.

Chairman SHELBY. On the Board of Directors, an Audit Committee?

Mr. ASHLEY. That is right, sir.

Chairman SHELBY. Were you ever on that Audit Committee?

Mr. ASHLEY. I was on that Audit Committee for a very brief time——

Chairman SHELBY. When was this?

Mr. ASHLEY [continuing]. ——at the end of 2004, for about 2 months at the end of 2004.

Chairman SHELBY. Oh, that is interesting. You were there for 2 months. Were you chairman of the Auditing Committee?

Mr. ASHLEY. No, sir, I was never chairman.

Chairman SHELBY. Who was chairman of the Audit Committee?

Mr. ASHLEY. At that time, Mr. Gerrity was chairman of the Audit Committee.

Chairman SHELBY. And who was the Chairman before that time?

Mr. ASHLEY. I would have to verify this. I believe it was Mr. Mai.

Chairman SHELBY. Mister who?

Mr. ASHLEY. Mai, M-A-I.

Chairman SHELBY. OK, how many members of the Board of Directors of Fannie Mae were on the Audit Committee of the Board of Directors?

Mr. ASHLEY. It would have varied over that time; anywhere, usually, from three to perhaps four or five members.

Chairman SHELBY. Did you ever interact with these members before you went on as a member of the——

Mr. ASHLEY. The chair of the Audit Committee reported regularly at each Board meeting following an Audit Committee meeting or an audit call.

Chairman SHELBY. Did you ever ask questions of the Audit Committee as a member of the Board of Directors?

Mr. ASHLEY. There were regular interchanges between all members of the Board and in response to the report of the Audit Committee chair to the Board.

Chairman SHELBY. Were there any questions asked about questionable accounting practiced during that time?

Mr. ASHLEY. Yes, sir; as the Freddie Mac issues became known, this was clearly a matter of discussion within the Board, and the Audit Committee chair was asked and reported on what KPMG had indicated to the Audit Committee.

Chairman SHELBY. Was Mr. Raines part of the Audit Committee when he was Chairman of the Board?

Mr. ASHLEY. Mr. Raines would not have been a member of the Audit Committee as a member of management.

Chairman SHELBY. Was Mr. Mudd ever a part of the Audit Committee?

Mr. ASHLEY. The same answer, Senator.

Chairman SHELBY. OK, all of that is troubling to me.

Senator Carper.

Senator CARPER. Thanks, Mr. Chairman.

As we wind up here, I want to come back and focus on a path forward and focus a bit less on the sins of Fannie Mae and those who ran this enterprise in recent years. I have asked Fannie Mae

to provide certain information to my office that we think will be helpful in crafting a legislative language with respect to portfolio limits.

Mr. Chairman, I will just say in my own State, I used to be Governor there, as you know, and made housing, especially homeownership, a big priority. And one of the things that I want to make sure that we do going forward is we address portfolio limits and what can go into a portfolio. I want to make sure that we do not somehow disadvantage our own housing authorities, whether they are State housing authorities or local municipal housing authorities in their ability to meet their missions of providing affordable housing.

I have said to Fannie Mae, it would be interesting to know how the assets in Fannie Mae's portfolios relate to the affordable housing missions of our housing authorities. I have asked for that information. They provided it for my State, and they are beginning to provide it for the other States.

I suspect I am not the only Member of this Committee that has asked Fannie Mae to provide information that might be helpful in enabling us to craft compromises in these two major areas: portfolios and affordable housing fund. Can you give us an example of any other requests for information that you have received, that you are mindful of from any of us, that you have provided a response for or maybe that you have not?

Mr. MUDD. Senator, as far as I know, we are relatively up to date on any requests for information from Congress. There has been, I think appropriately, an interest both in the activities of the company as they relate broadly to providing mortgage financing in each of the States as well as with respect to specific investment projects on a community by community basis. Any of that information that the Senators would like to see that is relevant to their States, we will provide.

Others have requested information in terms of our financial position and our capital related to the $39 billion in capital that we have related to the ongoing progress that we are making on the completion of the restatement related to how increasingly firm our understanding of how we are going to get that work done and when it is going to be done.

And for those and any other requests, we would be delighted, because my general view has been that the more information we can provide in terms of what we actually do, provided that we are doing it appropriately with the right set of controls and the right safety and soundness approach, the more we will be in the right space in terms of both our business and our mission.

Senator CARPER. In my time here in the Senate, from time to time, I have colleagues who say to me work with me on a particular issue. And what they really mean is accept my proposal. And I heard my friend Senator Martinez essentially say well, why do you not just embrace the language in the Senate Banking Committee bill as it pertains to portfolio limits?

And, you know, if this were a House Banking Committee, and the Chairman here and I used to serve on the House Banking Committee, my suspicion is that the House Banking Committee, if you were sitting before them, might say, well, why do you not just em-

brace our proposals with respect to portfolio limits and frankly with an affordable housing fund? And I do not know that it is appropriate for you to embrace either of these proposals.

Our responsibility, in my judgment, is to use you as a resource, to use the lessons that you have learned and we have learned through the misbehavior of those that you have worked with and to figure out what is the right thing to do going forward.

You can provide a great service for us in helping to address, I think, particularly these two issues. I do not think it is appropriate for us to say you should embrace either the language that is in our bill or, frankly, the language that is in the House bill but to give us the best advice and counsel from what you have learned and some hard lessons and to enable us to craft a better course going forward.

And I would close, Mr. Chairman, simply by stating what I have stated before: we ought to be able to work this out. The taxpayers of this country expect that from us. The folks who depend on these folks at Fannie Mae and Freddie Mac doing their job, they are depending on us as well. And I pledge to work with you to help us find that common ground.

Chairman SHELBY. Mr. Mudd, you said you were going to work with us. I assume Mr. Ashley as the Chairman is going to, too, but that will be soon tested in the next several weeks. You talked about this as a new Fannie Mae. We are going to see, because if you want to help us bring forth a substantive, meaningful bill, you are going to have that chance. We will have to wait and see.

Thank you for your testimony. The Committee is adjourned.

[Whereupon, at 3:02 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Letter Received from Kevin M. Downey to Chairman Shelby

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June 13, 2006

By Hand Delivery and Facsimile

Honorable Richard Shelby
Chairman
U.S. Senate Committee on
Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: June 15 Hearing

Dear Senator Shelby:

I have received your invitation for Frank Raines to testify at the Committee's June 15 hearing. Mr. Raines appreciates the invitation.

I regret that Mr. Raines must decline the invitation. He and his family are traveling abroad, beginning on June 13, on a long-planned vacation. Moreover, given that the matters raised in the OFHEO report are the subject of both pending and threatened litigation, we, as his attorneys, have advised him that it is more appropriate for him to answer those allegations as part of formal legal proceedings.

On behalf of Mr. Raines, we previously set forth in connection with Senator Rudman's investigation an analysis of some of the issues that will be the subject of the Committee's hearing. That analysis will be forwarded to the Committee staff under separate cover.

Very truly yours,

Kevin M. Downey

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

I want to thank you, Chairman Shelby, for holding today's hearing regarding the OFHEO Report of the Special Examination of Fannie Mae. This report not only confirms my deep concerns about Fannie Mae—it demonstrates that the GSE's actions were far worse than I could have imagined.

Nearly 3 years ago, as we've heard, after it was revealed that Freddie Mac had misstated its earnings, Senators Hagel, Sununu and I introduced legislation to strengthen the regulation of the GSE's. And Fannie and Freddie responded, dispatching an army of lobbyists to Capitol Hill and spending tens of millions of dollars to oppose our bill. In 2004, their lobbying tab totaled $26 million—and just last year, more than $24 million. At times it has truly felt like David and Goliath! No one has better described Fannie's mindset than the current CEO, who in an internal memorandum of November 2004 asserted, and I quote: "the old political reality was that we always won, we took no prisoners, and we faced little organized political opposition." End of quote. Even today, after all that we now know about Fannie and Freddie, the GSEs' influence on the Hill remains strong. But we in Congress must stand up to any political influence the GSEs continue to wield. The facts speak for themselves: On May 23 the Securities and Exchange Commission concluded that, and I quote, "between 1998 and 2004, Fannie Mae engaged in a financial fraud involving multiple violations of Generally Accepted Accounting Principles in connection with the preparation of its annual and quarterly financial statements." The SEC went on to explain that, "these violations had the effect, among other things, of falsely portraying stable earnings growth and reduced income statement volatility, and—for [the] year-ended 1998—of maximizing bonuses and achieving forecasted earnings" end of quote. Some had earlier claimed that Fannie and Freddie's problems were an understandable misapplication of complicated, obscure accounting rules. We now know that this was not the case—that in fact Fannie and Freddie were committing fraud . . . for many years . . . in part driven by certain executives' personal greed. There can no longer be any doubt about what we must do here in Congress—Fannie Mae and Freddie Mac need strong regulation, to ensure that fraud and manipulation in their accounting practices have been forever banished from these institutions. This report represents a clarion call . . . for the swift consideration and passage of legislation to create a new, independent regulator of these enterprises. This new regulator should have the authority to limit the sizable portfolios of both Fannie and Freddie, thereby redirecting the GSEs to their original mission and preventing them from engaging in activities that could undermine their safety and soundness, or place them in systemic risk

I thank both OFHEO and the SEC for their tenacious and diligent work on this issue. Director Lockhart, your report provides a detailed and complete exposé, not only of the many complex transactions that underlay the problems at Fannie Mae, but also of the broader culture of venality that developed at the GSEs. I thank you and the other witnesses for joining us here today.

PREPARED STATEMENT OF JAMES B. LOCKHART III

ACTING DIRECTOR,

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

JUNE 15, 2006

Good morning. Chairman Shelby, Ranking Member Sarbanes and members of the Committee, thank you for the opportunity to discuss the findings of our Special Examination of the Federal National Mortgage Association, better known as Fannie Mae. I will also discuss the settlement agreements reached by the OFHEO and the Securities and Exchange Commission (SEC) with Fannie Mae. My testimony reflects my views and not necessarily those of the President or the Secretary of Housing and Urban Development.

It is a pleasure to be here with Chairman Christopher Cox as the investigation and settlement agreements are excellent examples of government agencies working together. Before turning to a detailed discussion of the Special Examination and settlement, I would also note that later today OFHEO will submit its 2006 Report to Congress on the Examinations for both Enterprises pursuant to its statutory mandate.

As a Government Sponsored Enterprise (GSE), Fannie Mae has a special position among American corporations and an extremely important mission—facilitating the growth of affordable housing in the United States. Despite its recent downsizing, Fannie Mae remains one of the largest financial institutions in the United States.

As a GSE, Fannie Mae has a special mandate and position of public trust. The previous management team, led by Chairman and Chief Executive Officer (CEO) Franklin Raines, violated that trust. By encouraging rapid growth, unconstrained by proper internal controls, risk management and other systems, they did serious harm to Fannie Mae while enriching themselves through earnings manipulation.

Let me provide a brief history about OFHEO's Special Examination. Despite Fannie Mae's protests, in July 2003, OFHEO informed this committee that it intended to conduct a special accounting review of Fannie Mae to evaluate whether it complied with Generally Accepted Accounting Principles or GAAP.

In September 2004, OFHEO issued an interim report that detailed serious problems relating to Fannie Mae's accounting. Importantly, OFHEO found that Fannie Mae did not comply with GAAP for FAS 91, which deals with amortization of loan fees, premiums and discounts, and FAS 133, which covers derivatives and hedge accounting. The SEC concurred with OFHEO's findings and ordered Fannie Mae to restate its financial statements filed with the Commission.

Since then, OFHEO and the Board of Directors of Fannie Mae have entered into three agreements requiring remedial steps. The last agreement was signed on May 23, 2006.

The OFHEO report details an arrogant and unethical corporate culture. Perhaps the best written record of this culture is a memo from the Chief Operating Officer to the CEO 2 months after OFHEO's interim report. He was discussing the need to change and wrote: "The old political reality was that we always won, we took no prisoners . . . " and he added, "we used to . . . be able to write, or have written rules that worked for us."

Fannie Mae's management directed employees to manipulate accounting and earnings to trigger maximum bonuses for senior executives from 1998 to 2003. The image of Fannie Mae as one of the lowest-risk and "best in class" institutions was a façade. The examination found an environment where the ends justified the means

Senior Fannie Mae executives were precisely managing earnings per share (EPS) to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems, internal controls, and risk management. The combination of earnings manipulation, mismanagement, and unconstrained growth resulted in an estimated $10.6 billion of overstated profits, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars. Senior executives were flat-out wrong, or, to use the proper regulatory phrase, were managing Fannie Mae in an "unsafe and unsound" manner. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing about it. They co-opted their internal auditors and other managers. They stonewalled OFHEO.

The Board of Directors, the last line of defense, failed to be sufficiently informed and independent. Their oversight failings meant that they did not discover, let alone correct, the unsafe and unsound practices at Fannie Mae, even after the Freddie Mac problems became apparent.

Management Manipulated Earnings

During the period covered by our report, Fannie Mae reported extremely smooth profit growth and hit EPS targets with uncanny precision each quarter. By deliberately and intentionally manipulating accounting, senior management maximized their bonuses and other compensation, which came at the expense of shareholders. In 1998, management should have recognized significant losses from the amortization of premiums and the impairment of guaranty-fee buy-ups, but much of the actual loss was deferred so that management could meet bonus targets, as well as the expectations of analysts. In other years, such as 2001, when very low short-term rates resulted in higher-than-forecasted earnings, management engaged in various manipulations, including debt repurchases and structured transactions with no legitimate business purpose, to save earnings for a rainy day. For example, the total compensation of former Chairman and CEO Frank Raines exceeded $90 million from 1998 through 2003. Of that amount, more than $52 million was directly tied to achieving EPS targets.

Senior executives at Fannie Mae consistently reminded managers and other employees of their personal stake in meeting EPS targets. Indeed, the head of the Office of Auditing told his staff, in reference to Chairman Raines' goal of doubling earnings per share from $3.23 to $6.46 by 2003, that they must have "$6.46 branded in their brains." That statement implies a blatant conflict of interest for an internal auditor.

Now, I want to spend a few minutes briefly describing the accounting tools that management used to achieve their desired earnings targets and the control environment—or lack thereof.

Specific Accounting and Earnings Management Issues

In brief, the extreme predictability of the financial results reported by Fannie Mae from 1998 through 2003, and the ability to hit EPS targets precisely each quarter, were illusions deliberately and systematically created by management. The real question is how was management able to accomplish this when their business is volatile by nature and accounting was moving toward measuring and reporting assets and liabilities at fair value.

First, they had to assure that large unpredictable changes in fair value were not recognized. FAS 115, Accounting for Certain Investment in Debt and Equity Securities and FAS 133, Accounting for Derivative Instruments and Hedging Activities are examples of accounting standards, if implemented properly, that would have recognized and recorded earnings volatility. Faced with that outcome, Fannie Mae chose to implement these and other accounting standards in a fashion that reduced volatility while ignoring the fact that these practices did not comport with GAAP.

During this same period, Fannie Mae management went to extraordinary lengths to avoid recording GAAP-required impairment losses on assets whose values had declined. Examples of such assets are manufactured-housing and aircraft-lease-backed securities, interest-only securities, and "buy-ups." Not only did they not record these losses but the report details the extraordinary measures management took to keep this information off the books and out of the view of their external auditor and regulatory bodies.

By utilizing the above strategies, management was able to keep earnings within a predictable range, placing management in a position to employ several techniques to manipulate and manage earnings more directly, including the use of cookie-jar reserves, income shifting transactions and inappropriate debt repurchases.

The natural question at this juncture is where were the internal controls that should have prevented this type of behavior and where were the internal and external auditors? The report details the conscious decision made by management to use existing systems even when proper implementation of new accounting pronouncements and rapid growth necessitated the need for new systems. It also discusses the weak internal control environment that management created or allowed to exist. In fact, this underinvestment in internal controls, accounting systems, risk management, and staff helped them to manage earnings as it made it much easier to hide improper actions that smoothed earnings.

The report also discusses the serious failures in the Office of Auditing. Internal Audit failed to properly confirm compliance with GAAP as specified in its audit objectives or to consistently audit critical accounting policies, practices, and estimates in a timely way. When Internal Audit did find shortcomings they were not adequately addressed or communicated. Internal Audit failed to perform its primary task and issued misleading reports about its work. Finally, it failed to exercise due professional care in investigating allegations of accounting improprieties raised by two employees in the Office of the Controller.

Similarly, external audits performed by KPMG failed to include an adequate review of Fannie Mae's significant accounting policies for GAAP compliance. KPMG was aware of the non-GAAP provisions of Fannie Mae's FAS 91 policy as well as the non-GAAP practices the Enterprise was using in the application of FAS 133. That notwithstanding, KPMG issued unqualified opinions on Fannie Mae's financial statements for the years in question when these statements included significant departures from GAAP. Last, the external auditor performed a cursory review, at best, of the allegations of fraud raised by Roger Barnes. The procedures performed by the external auditor were not sufficient to make a determination regarding the propriety of the internal investigation performed by Fannie Mae or to evaluate the Enterprise's conclusions regarding Mr. Barnes' assertions.

The Role of the Board

The Board-approved executive compensation program at Fannie Mae sent senior executives the message to focus on increasing earnings rather than controlling risk. Indeed, during much of the period covered by the report, Fannie Mae took significant amounts of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses, despite the smooth reported earnings. Fannie Mae also had significant operational risk exposures.

The report also provides some insight on matters of corporate governance that gave rise to many of these problems. For example, the Special Examination found that the Board of Directors of Fannie Mae contributed to the Enterprise's problems

by failing to be sufficiently informed and failing to act independently of its chairman, Frank Raines, and other senior executives. The Board failed to exercise the requisite oversight over the Enterprise's operations, and failed to discover or ensure the correction of a wide variety of unsafe and unsound practices. These failures occurred even after serious accounting and earnings management problems at Freddie Mac became widely known.

In particular, the Audit Committee did not provide adequate oversight of the internal audit function, and did not monitor the development and implementation of critical accounting policies. These failures resulted from the Committee's own neglecting to develop the specialized financial knowledge necessary for its oversight responsibilities. The Audit Committee also failed to initiate an independent investigation of Roger Barnes' whistleblower claims of accounting irregularities when they arose.

The failure of the Audit Committee was compounded by failures of the Compensation Committee. The primary role of this committee is to ensure that senior management is properly compensated for its role in directing the affairs of the Enterprise. Nevertheless, the Compensation Committee approved a compensation structure based on a single measure that was easily manipulated by management. The Compensation Committee also did not monitor the executive compensation system for signs of abuse by senior management.

Recommendations

Based on the report's findings, staff made specific recommendations to me, as Acting Director, to enhance the safety and soundness of Fannie Mae. I have accepted all of the recommendations. Several of them were directed to OFHEO, including:

- OFHEO needs to continue to strengthen and expand its regulatory infrastructure and regular examination programs.
- Matters identified for remediation by Fannie Mae should be considered for Freddie Mac.
- OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at Fannie Mae and Freddie Mac.

However, the majority of these recommendations are directed at Fannie Mae and I am pleased to say they have all been incorporated into the agreement that was signed on May 23, 2006.

Settlement

OFHEO reached a settlement with Fannie Mae to address the various problems found in the course of the Special Examination. The settlement represents a step toward correcting a dangerous course that had been followed by one of the largest financial institutions in the United States. Unprincipled corporate behavior and inadequate controls simply will not be tolerated. The settlement addresses both specific misconduct and weaknesses as well as the overall culture that permitted such misconduct and mismanagement to occur.

I am pleased that the settlement reached by OFHEO could be concluded at the time the Report of the Special Examination was released and in close consultation and cooperation with the SEC. Chairman Cox said at the OFHEO press conference, "Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets to allocate capital to its best uses."

The key components of the agreement, that contains nearly 60 remedial provisions, include:

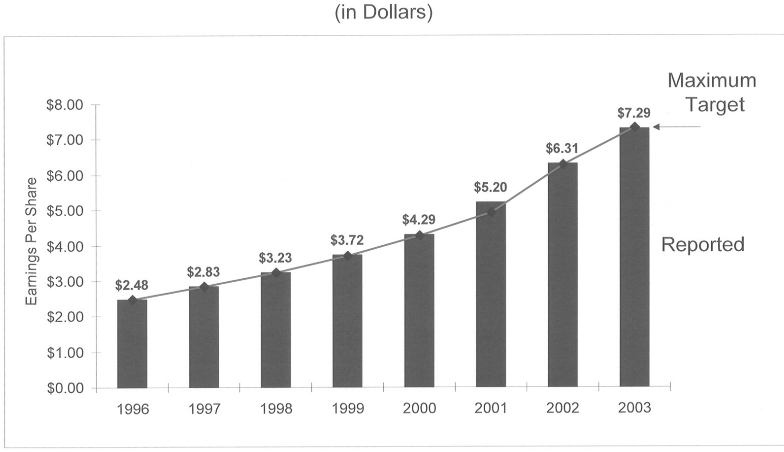
- OFHEO directed Fannie Mae to pay a $400 million penalty to the government. This level of penalty signals that unsafe and unsound conditions cannot be tolerated at firms that have a public mission and enjoy public benefits.
- OFHEO directed that Fannie Mae freeze the growth of its portfolio mortgage assets to the level of December 31, 2005. OFHEO's action is based on the ongoing internal controls, risk management and accounting deficiencies and the need for the Enterprise to provide OFHEO an acceptable business plan for managing its market activities. Sole discretion lies with the Director of OFHEO to modify or lift the limits based on his assessment of plans and progress. The preexisting surplus capital requirements and capital planning along with limits on corporate actions such as dividend payments remain in effect.
- Fannie Mae must strengthen its Board of Directors procedures to enhance Board oversight of Fannie Mae's management and the Enterprise must create new Board committees to address new legal and reporting obligations and must demand and receive improved reporting to the Board by management.

- Fannie Mae must make a major investment in internal controls. From a clear policy on the role of outside consultants to external testing of controls and greater emphasis on operational risk to simple, prudent controls for ledger entries, the Enterprise must address its control environment that suffered under prior management. The external relations program must be reviewed and internal controls created as well.
- Fannie Mae must remediate its accounting structures, personnel, and reports to management and the Board. Accounting staff must be skilled and adequately funded and significant transactions must be flagged and detailed for the Board.
- Fannie Mae is undertaking a review of current and separated employees who are mentioned in our report for remedial actions; additional employees discovered during this review may be subject to sanction. This review is underway and OFHEO monitors the Enterprise's progress. If the Enterprise does not or cannot proceed, then OFHEO will proceed against individuals under the authority it possesses. Chairman Cox indicated that the SEC is undertaking its own review for possible action against personnel involved in matters within its jurisdiction.
- Fannie Mae must establish succession plans; comprehensive budget, staffing, and training plans for individual offices; and must continue to work with OFHEO on its determinations regarding appointments to senior offices. Fannie Mae is directed to put in place qualified individuals with appropriate skills and adequate resources, and to provide a strong training program that includes training on the code of conduct and law compliance.
- Fannie Mae must assure that compensation programs are not tied solely to EPS measures.

The emphasis on specific reforms is coupled with requirements to alter tone and culture. These are critical to any company. Be it direct action or the failure to correct behavior—that is, be it intentional policy or a policy of neglect—the key to most corporate failures is tone at the top. OFHEO's settlement seeks to remedy both the conduct and the culture that permitted that conduct at Fannie Mae.

Finally, let me note that the remedial steps undertaken by OFHEO underscore the need for legislation. If the agency had sufficient budget authority to enhance its staff, more robust legal authority over individuals and those affiliated with the Enterprise, other powers similar to those of other financial regulators including receivership, flexible capital standards, new product and growth controls, and more streamlined enforcement authorities, then there is a strong possibility OFHEO could have prevented the many unsafe and unsound practices cited in our report rather than seeking to remedy them through settlements. Clear and explicit authorities aimed at remediation will have a beneficial effect in prevention of unsafe practices. OFHEO clearly needs legislation to make this a reality. That concludes my prepared remarks.

Earnings Were Manipulated to Hit Maximum Bonus Targets
1996 – 2003
(in Dollars)



PREPARED STATEMENT OF CHRISTOPHER COX

CHAIRMAN,

U.S. SECURITIES AND EXCHANGE COMMISSION

JUNE 15, 2006

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for giving me the opportunity to be here today to testify about the Securities and Exchange Commission's recent enforcement action against the Federal National Mortgage Association ("Fannie Mae"). Under Chairman Shelby's leadership, this Committee has spent a great deal of time and effort examining the issues surrounding Government-Sponsored Enterprises and I appreciate the opportunity to appear before you this morning on behalf of the Commission.

SEC Enforcement Action Against Fannie Mae

On May 23rd, the Commission and the Office of Federal Housing Enterprise Oversight jointly announced settlements with Fannie Mae for accounting fraud. The settlements require the company to pay a penalty of $400 million. This is a meaningful penalty designed to deter future misconduct. Moreover, as a result of the Fair Fund provisions of the Sarbanes-Oxley Act, most of the penalty will likely be used to compensate defrauded investors. Both Director Lockhart and I agree that a penalty of this size represents a meaningful sanction that is necessary to address the egregiousness of Fannie Mae's conduct. Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets to allocate capital to its best uses.

By interfering with the full and fair disclosure that underpins our markets, fraudulent financial reporting cheats investors of their savings. That is why the extensive financial fraud that you will hear described today required such an emphatic deterrent response.

The Commission's action alleges that Fannie Mae misstated its financial statements from at least 1998 through 2004. In settling these charges, Fannie Mae has agreed to pay $400 million, the lion's share of which will be paid to the Commission, who will in turn return it to defrauded shareholders through our Fair Fund program. Fannie Mae also agreed to be permanently enjoined from future violations of the anti-fraud, reporting, books and records, and internal control provisions of the Federal securities laws.

The significance of the corporate failings at Fannie Mae cannot be overstated. The company has said that it estimates the restatement of its financial statements for the years ended December 31, 2003, and 2002, and for the quarters ended June 30, 2004, and March 31, 2004, will result in at least an $11 billion reduction of previously reported net income. In all likelihood this will be one of the largest restatements in American corporate history.

Fannie Mae's size and status make it a financial giant. Yet despite its prominent position in the financial marketplace the company's internal controls were wholly inadequate in light of the size, complexity, and sophistication of Fannie Mae's business. Its failure in key areas highlights the critical need for senior management to constantly assess internal controls as their business grows. Such an investment is necessary for the good of the business, for the protection of shareholders, and for the health of our capital markets. Fannie Mae is a clear example that neglecting internal controls can be devastating for a company and its investors.

The Commission's complaint lays out in detail the many accounting failures that occurred at Fannie Mae from books and records violations to fraud. The complaint also describes the corporate culture at Fannie Mae that emphasized stable earnings growth and reduced income statement volatility that was the backdrop for the fraud. As a result of this conduct, the company's financial results were smoothed through misapplications of Generally Accepted Accounting Principles, or GAAP.

Two accounting principles are critical to Fannie Mae's business: accounting for nonrefundable fees and costs associated with loans, known as Financial Accounting Standard 91, or FAS 91, and accounting for derivative instruments and hedge activities, known as FAS 133.

In connection with FAS 91, the Commission's allegations contained two key components. First, at the end of 1998, senior management intentionally manipulated earnings in order to obtain the highest available bonus payout. Senior management of the company determined that certain expenses would not be booked even though GAAP required they be recorded. At the same time, senior management engaged in a series of additional inappropriate adjustments to the company's income statement so that the company hit the earnings per share target necessary to trigger maximum management bonuses.

Second, under FAS 91, companies are required to recognize loan fees, premiums and discounts as an adjustment over the life of the applicable loans. For groups of similar loans, a company can use estimates of prepayments to calculate the effective interest rate of the loans and determine the portion of such fees and related items to be recognized in the income statement. If actual prepayments differ from estimates, or estimates change, the net investment in the loans must be adjusted with an offsetting entry to the income statement. From before 2000 through 2004, Fannie Mae improperly used a threshold to determine when certain of these adjustments would be recorded to its income statement. If the amount to be recorded did not exceed the company-calculated threshold, Fannie Mae did not record it. This practice was an improper departure from GAAP and had the effect of reducing earnings volatility.

In connection with FAS 133, without proper basis in the relevant accounting literature, Fannie Mae sought to fit the vast majority of its transactions into a simplified method of applying hedge accounting that assumed no ineffectiveness in the hedge relationship. By assuming no ineffectiveness, Fannie Mae avoided measuring and recording in its income statement the difference between the change in value of its derivatives and the change in value of the items being hedged by the derivatives.

The transactions in question simply did not qualify for such treatment under FAS 133. One reason Fannie Mae adopted this approach was that it did not have adequate systems or personnel in place to comply with FAS 133's provisions—in particular, with provisions that require periodic assessment of effectiveness and measurement of ineffectiveness. Had Fannie Mae applied such provisions, it would have resulted in income statement volatility that senior management of the company wanted to avoid. Most of Fannie Mae's anticipated restatement of at least an $11 billion reduction of previously reported net income is a result of its improper hedge accounting.

The Commission continues its investigation regarding the individuals and entities whose actions and inactions have led to this result. The public should have full confidence that we will vigorously pursue those individuals who have violated the Federal securities laws. Until the investigation is complete, I cannot comment further on the alleged conduct of particular individuals or the specific stage of the investigation.

Improved Disclosure to Fannie Investors

Fannie Mae's settlement of accounting fraud charges raises another very significant policy issue, one that has been carefully considered by members of this Committee: whether to require mandatory registration and periodic reporting under the Exchange Act by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

As you well know, the securities issued by Fannie Mae are "exempt securities" under current laws administered by the SEC. However, there is no question that the word "Government" in "Government-Sponsored Enterprises" leaves many members of the investing public with the mistaken impression that GSE securities are backed by the full faith and credit of the U.S. Government, when in fact there is no such guarantee.

For this reason, the Commission—going at least as far back as 1992—has consistently advocated the view that, because GSEs sell securities to the public, have public investors, and do not have the "full faith and credit" government backing of government securities, GSE disclosures should comply with the disclosure requirements of the Federal securities laws.

In July 2002, Fannie Mae took a step forward by announcing that it would voluntarily register its common stock with the SEC under Section 12(g) of the Exchange Act. The registration of its common stock became effective on March 31, 2003, and Fannie Mae subsequently began filing periodic reports with the SEC. Unfortunately, many of Fannie Mae's periodic disclosures have been late or incomplete. Most notably, Fannie has to date not filed an annual report (10-K) for either 2004 or 2005, and has not filed quarterly reports (10-Q) in any of the preceding seven quarters.

While our recent enforcement action has assuredly focused the attention of Fannie Mae's management on improving its disclosure to investors, there is no question that, in the future, Fannie Mae would be far more likely to maintain consistent compliance with our disclosure regime if the Congress were to terminate its special status of voluntary registration and reporting, and make its registration and reporting mandatory. That, in my view, is a far better way to protect investors.

I know this Committee is considering legislation that would require compliance with the Exchange Act periodic reporting requirements by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I commend you for your attention to this issue, and encourage your consideration of this legislation. As I mentioned, the Com-

mission has historically been in strong support of mandatory compliance by the GSEs with these disclosure requirements. We stand ready to support you in these efforts, and will be prepared to enforce mandatory compliance, should you choose to change the requirements for these Government-Sponsored Enterprises.

I also wanted to bring the Committee up to date on a related issue of the New York Stock Exchange's rules, which authorize suspension and delisting when a listed company fails to file its annual report with the SEC in a timely manner. As you know, because of Fannie Mae's failure to file its 2004 and 2005 annual reports on time, the NYSE amended its general delisting rules to provide a unique exemption for Fannie Mae, though it is not specifically phrased in those terms.

Since NYSE put this new rule in place, questions have been raised about whether this exemption is appropriate. As I testified before this Committee on April 25, 2006, the exemption needs to be considered in light of the unusual circumstances not only of Fannie Mae's voluntary transition to Exchange Act financial reporting compliance, but also its massive restatement. I also expressed my view that this exemption must be temporary, only for the purpose of allowing Fannie Mae to come into initial compliance with Exchange Act reporting. To respond to concerns that this exception might become a permanent, rather than temporary, policy, I want to inform the Committee that we have encouraged the NYSE to amend its rule to put an expiration date on this exception, so that Fannie Mae—and its investors—understand that we expect Fannie Mae, like any other listed company, to remain in full compliance with NYSE's listing standards.

In conclusion, the Commission's action against Fannie Mae and its position on the appropriate treatment of Government-Sponsored Enterprises under the Exchange Act's periodic reporting regime are animated by the same principle—that investors are best served by applying the Federal securities laws in an even-handed and judicious manner to all companies participating in the public markets.

Thank you again for giving me the opportunity to be here today. I am pleased to try to respond to any questions you may have.

PREPARED STATEMENT OF STEPHEN B. ASHLEY

CHAIRMAN OF THE BOARD OF DIRECTORS,

FANNIE MAE

JUNE 15, 2006

Mr. Chairman, Senator Sarbanes, and Members of the Committee. My name is Stephen B. Ashley. I have been in the mortgage business for over 40 years, and the last time I had the privilege of testifying before this Committee was when I served as President of the Mortgage Bankers Association of America. I appreciate the opportunity to appear before the Committee today.

Eighteen months ago, I was asked to become independent Chairman of the Fannie Mae Board of Directors, whose job it is to protect the interests of shareholders and stakeholders by holding management accountable, putting in place the proper corporate governance, and ensuring that the company is operated in a safe and sound manner.

The Fannie Mae of 1998–2004 portrayed in the final OFHEO report of its special examination is a far different company than was portrayed to the Fannie Mae Board by departed management, our former external auditor, and annual regular examination reports. I would like to comment briefly on the Board and the company's response to the OFHEO special examination of Fannie Mae and the changes we have made and are continuing to make to address the problems identified.

On September 20, 2004, when we received OFHEO's interim report, we acted immediately to examine and respond to its findings. Within a week of receiving the report, we reached an agreement on a process to resolve the issues raised by the report, we pledged to work cooperatively with OFHEO, and we began supervising the work of fixing the company.

Also in September 2004, the Special Review Committee of the Board initiated an independent review of the issues raised in the OFHEO report and other matters relating to the company's accounting, governance, structure, and internal controls. To conduct the review, the Committee engaged former Senator Warren Rudman and his law firm of Paul, Weiss, which retained the services of a forensic accounting firm. The Board directed that the work of Paul, Weiss be transparent to OFHEO, the SEC and the Department of Justice through the entire period of the review.

In October 2004, the Board established an ongoing Compliance Committee to ensure that the company fulfilled its agreement with OFHEO and all the company's legal and regulatory obligations.

By the end of 2004, working with OFHEO, we had taken action to replace our outside auditor; launch our restatement; and replace our Chief Executive Officer and Chief Financial Officer. Since September 27, 2004, the full Board has met 43 times; Board Committees have met 146 times. Since January 1, 2005, I have met directly with the Director or Acting Director of OFHEO 17 times. As independent Chairman of Fannie Mae, I typically spend 2 to 3 days a week at the company, providing direct oversight.

In March, 2005, the Board also entered into a supplemental agreement with OFHEO to enhance Fannie Mae's internal financial controls and accounting policies and practices to ensure they conform to GAAP, disclosure and other regulatory standards.

We also agreed to take steps to further strengthen the company's corporate governance. Let me describe some of these and other changes the Board has made:

- We separated the roles of the chief executive officer and the chairman of the board, as it was essential to establish the appropriate governance and oversight of management, assuring all parties that we were progressing on our agreed upon goals.
- Five of the 12 nonmanagement members are new since 2004, and the newest member, Dennis Beresford, is a former chairman of the Financial Accounting Standards Board and will serve as chairman of the Audit Committee. All five of the new Board members are independent of management. We eliminated two of the seats held by management, retaining just one, to increase the proportion of independent board members.
- In addition, in accordance with our corporate policy and OFHEO's corporate governance rules on length of service, another Board member, Ann Korologos, will be leaving the Board effective July 31. As lead director and chairman of the Governance Committee in 2004, she felt it was her duty to remain on the Board an extra 2 years to see us through the investigative phase, which is now complete.
- To ensure accountability and the timely flow of information, we established reporting lines to the Board for the positions of Chief Audit Executive, Chief Compliance and Ethics Officer, and Chief Risk Officer.
- To improve our relationship with our regulators and to hear about any problems directly, I and other members of the Board have established regular interactions with OFHEO.

During this period the Board exercised one of its paramount functions: to select and review the performance of the CEO of the company. We made a change in leadership at Fannie Mae when we appointed Dan Mudd as interim CEO of Fannie Mae on December 21, 2004.

We directed Mr. Mudd to begin working with the Board and OFHEO to implement our regulatory agreements, carry out other necessary and appropriate changes to the company, and put Fannie Mae on a new track.

More specifically, we made clear that his duties included the following:

- Restoring the company's capital;
- Restating Fannie Mae's financial results;
- Building a new management team, particularly in the areas of finance, accounting, and audit;
- Rebuilding relationships with regulators, customers, and stakeholders;
- Garnering credibility with the investment community, both the debt and equity markets;
- Boosting the company's investments in our financial systems and internal controls; and
- Rebuilding the company's culture on a foundation of service, respect, and openness.

In June 2005, the Board selected Dan Mudd as permanent President and CEO of Fannie Mae, after an extensive, competitive nationwide search and careful and deliberate consideration, including consultation with OFHEO and a very thorough review by Senator Rudman. As interim CEO, Mr. Mudd demonstrated an ability to lead a large financial institution through a major and challenging transition, including the ability to reach out and rebuild confidence with our regulators, Congress and others. He demonstrated his capacity for the job by doing the job.

On May 23 of this year, the company took a big step forward when we reached settlements with the Securities and Exchange Commission and OFHEO. The settlement with OFHEO addresses the recommendations found in the OFHEO final report. The Board is committed to ensuring full and total compliance with these agreements.

Mr. Chairman, I can report to this Committee that there is a strong determination—on the part of the Board, management, and employees—for Fannie Mae to grow into a very different company than it was from 1998 to 2004, and that changes have been made up, down and across the organization. At the same time, the Board understands that Fannie Mae has much more to do, and working with our regulators and with this Committee and the counterpart committees in the House, we intend to hold ourselves and the management team accountable for the changes that need to be made.

I welcome this chance to report to you and to answer any questions you have.

PREPARED STATEMENT OF DANIEL H. MUDD

PRESIDENT AND CEO,

FANNIE MAE

JUNE 15, 2006

Mr. Chairman, Senator Sarbanes, and members of the Committee. My name is Daniel H. Mudd, and I appreciate the opportunity to appear before you today to update you on the progress we have made at Fannie Mae, where I have served as Chief Executive Officer since December 2004.

The final OFHEO report, and the special investigation by former Senator Warren Rudman and the law firm of Paul, Weiss for our Board of Directors, have provided a detailed picture of the failings at Fannie Mae during the years 1998 through 2004.

I appreciate the opportunity to comment on that period, and I would like to report on what we have done to overhaul the company since the start of 2005, and also respond to your questions.

It is clear from the reports that Fannie Mae got a lot of things wrong from 1998 to 2004. Bad decisions about accounting and many other matters let a lot of people down, and in doing so, broke a public trust. We have learned some painful lessons about getting things right, and about hubris and humility.

We have made changes. We are making progress. And we have much more to do. I am determined to do it.

We began with a plan to fix the company on December 21, 2004, the day I was appointed as Fannie Mae's interim CEO. We set out to: Restore our capital; restate our prior financial statements; rebuild relationships with our regulators, partners, stakeholders, and Congress; manage our business; recenter the company on serving families who need affordable housing; armor-plate our financial controls; and finally, fix our corporate culture, which the OFHEO report makes clear led to a lot of our problems.

I have heard your comments today, and I have heard many more in private. The days of arrogant, defiant, "my way" Fannie Mae had to end. We have begun to build a Fannie Mae that listens better, welcomes accountability, works with our regulators and with Congress, and serves the market by putting our mission to serve housing first.

Let me describe some of the tangible steps we're taking, starting with the people.

First, we have established a new senior management team to provide the leadership, talent and ethical standards worthy of our role and mission.

Of the 55 members of the company's senior-most management, 75 percent are new or in different positions and a third are entirely new to the company, especially in the critical finance, accounting, and risk areas.

We have a new Chief Financial Officer, we have a new Controller, a new Chief Audit Executive, a new Chief of Accounting Policy, we have a new General Counsel, a new Chief Risk Officer, and a new head of Corporate Strategy. These leaders join us from important roles in major financial institutions, large corporations, and highly regarded firms.

Second, in cooperation and consultation with OFHEO, we are fundamentally reorganizing the company to ensure that strong checks and balances are in place. For example:

- To ensure appropriate segregation of duties, we have separated the portfolio business from the CFO's responsibilities.
- Under the new CFO, we have reorganized the Finance function and brought in entirely new leadership from outside the company.
- We are reorganizing and strengthening Internal Audit, and the new Chief Audit Executive has a direct and independent line to the Board's Audit Committee.

We have also replaced our outside auditor with Deloitte and Touche, which is conducting a comprehensive re-audit of the entire company. Deloitte, which formerly

provided advice to OFHEO when several of the accounting problems were first identified, has over 300 auditors onsite at Fannie Mae.

We are making further key organizational changes, which include:

- Establishing a new and separate Compliance and Ethics Organization to provide a robust compliance and internal investigation function, led by a senior executive, with a reporting line to the Board. We have written and pledged ourselves to a standard of ethical, honest, and transparent conduct inside and outside the company.
- Establishing a new Risk Organization with an independent and comprehensive view of all the risks the company is taking, and again, with a reporting line to the Board. We have recruited and hired a senior executive from JP Morgan Chase to lead this function.
- Disbanding the so-called Law and Policy division so that each function reports directly and separately to me. These are staff functions that exist to support our business and our mission—not a center of command and control.

Third, we have restored and maintained our capital adequacy, including the 30-percent surplus mandated in our agreement with OFHEO and supervised by their examiners. We now have roughly $39 billion dollars of capital in reserve; our ratio of capital to assets is higher than it has ever been in our history.

Fourth, we are paying people to do the job—not to hit targets. We have adopted a new executive compensation structure with broad performance goals that include achieving affordable housing mission goals, improving our culture, complying with regulatory standards, and delivering shareholder value.

Fifth, we are making steady progress on completing our financial restatement, which will be done by the end of 2006.

We have put over 1,000 full-time and 2,500 contract employees on the job and invested over $800 million, a large part of that on new systems. We have completed an exhaustive review of our accounting policies and practices to determine their consistency with Generally Accepted Accounting Principles.

We have completed the restatement of several, significant portions of our balance sheet, and developed systems to support and control our business. We are in the process of putting in place systems and controls to ensure we are GAAP and Sarbanes-Oxley compliant. There is absolutely no routine, process, or control anywhere in the company that is beyond the scope of overhaul and improvement to the highest standard. We have over 150 projects underway and 200 associates working on this alone. We can get this done—our overarching goal is to get it done right the first time, and to make the investments to ensure this never happens again.

Mr. Chairman, I would like to reiterate a commitment I made in my testimony last April, that Fannie Mae will work cooperatively to support the efforts of Congress to pass legislation to strengthen GSE regulation.

In particular, we continue to support legislation to create a strong, well-funded regulator that would oversee both the safety and soundness and the housing mission of the enterprises.

We believe the regulator should have bank-like regulatory powers, including the authority to reduce on-balance sheet activities, based on safety and soundness. We also support housing goals, and an affordable housing fund, that strengthen our affordable housing mission and our role in the U.S. housing economy.

With respect to how we engage with Congress—that is part of the new Fannie Mae as well. I hope you have seen a new tone and manner of quiet, fact-based engagement from us. Where we disagree, we do so respectfully. You have my pledge to do all we can to help move this process forward.

Mr. Chairman, from the day I was appointed to lead Fannie Mae, we have been moving forward aggressively to fix the problems OFHEO has cited. The question may be, why is this worth doing? The reason this company exists is because of our housing and liquidity mission to help put people into homes.

Indeed, in these past 18 months:

- We have purchased or guaranteed more than four million home loans.
- We helped to create 136,000 more minority homeowners and serve 600,000 low- and moderate-income families overall.
- We helped provide financing to build, rehab or refinance 600,000 units of affordable rental housing.
- Nearly two-thirds of our overall business serves one or more of our HUD affordable housing goals.
- We are investing literally billions of dollars in the Gulf Coast region to help finance and rebuild homes and communities there.

- We attracted more than $21 billion of overseas investment to provide liquidity to the U.S. housing finance market.
- Most important, we are providing what we estimate is roughly half a trillion dollars this year to finance homes for three million Americans, 25 percent of them African-American, Hispanic, and/or first-time home buyers.

I know that you are counting on us to fulfill our mission, and help to serve this growing Nation and its growing housing needs. That is what makes this worth doing.

Mr. Chairman, this company is changing and will continue to change thanks to the lessons we have been given to learn. My obligation and pledge to you, the Congress, and the market we serve is to get this right and move forward. We are building a new Fannie Mae that is able to truly serve affordable housing in America.

I thank you for the opportunity to appear before you today. I look forward to your questions.

Addendum

Memo to Frank Raines from Dan Mudd

To: Frank Raines
From: Dan Mudd
Dtd: November 16, 2004

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Frank, you asked for some thoughts around your comments at the Officer's meeting. I've been putting some ideas down on paper over the past couple of months as material for my 2005 Sales and Marketing, HCD, and e-business speeches. This is in memo form to you. I hope it's helpful.

The 11/12/04 document called "FDR Context Setting Remarks" does not seem on target to me. I agree that there is huge appeal to you talking from the heart at the beginning—there is much positive talk about that part of your testimony inside and outside the company. But the rest of the document is meandering, grab-baggy, and doesn't really have any obvious takeaways. I think you may need to be a little more directive to be most effective.

"Dealing with a New Reality"

I believe our people understand that many of the old realities of FannieMae's competitive, political, strategic and internal environment have changed--- but they need a framework for thinking about new realities. Admittedly, we don't know how some of the new realities are going to work out, yet the organization (the flywheel) is losing momentum waiting for a full definition of the future. The Officer's Meeting provides an opportunity to remake the old realities, and get the team looking ahead to a better future and a stronger company.

A few GE adages come to mind: "most mistakes that leaders make arise from not being willing to face reality and act upon it" and "face reality as it is, not as it was or as you wish it to be." We may be wishing for an old reality in several areas. In fact, in many of cases, the new reality puts us in a league with "normal" companies: GDP-type growth; intense competitive pressure; muscular regulation; skeptical investors, stakeholders and directors; employees with a "term" mindset.

The good news is that management actions to deal with the new reality have begun (ad hoc) in many areas. I think the Officers need you to weave it all together and create a comprehensible framework that recreates a strategic "safe house" where they can lead, act and decide.

The Market

The old reality for the careers of many, many of our associates has been a steady, favorable market. You have pointed out yourself how much your associates in other industries envy the 10-12% growth in the mortgage industry. The new reality is that we're going to have a few years (at least) of lower growth. And even that growth exceeds the 3-4% GDP-type market that is typical in most industries. In a way, we have moved to the next phase in the life cycle of corporations--- from high growth to maturing. If you lop off a few zeros, it makes sense. In entering this phase, typical companies move from go-go to controls; from entrepreneurship to institutionalization; from bare bones to higher expense ratios; from customer acquisition to risk management--- paralleling our needs.

To maintain corporate growth, we will need to continue the engagement/alignment work we have already started with our customers, to maintain our product development, and to support the creation of new business lines (a la Multifamily and e-business). Officer's guidance:

- Learn to operate in a lower growth market (expenses, investor relations, products that lower lender and consumer costs, buy new portfolio asset types).
- Create one potential new business a year.

Politics and Regulation

The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition. The new reality is that four years of continuous fighting has worn out even our friends; we no longer get the benefit of the doubt: we are presumed to be behind any political action in the mortgage industry, to "control" the NAHB, NAR, MBA and others. The fight has resulted in relationships with all these bodies that are <u>worse</u> than when we started, and the new reality is that legislation CAN happen without our acquiescence. And finally, all of this action has supplanted our "affordable homeownership" brand with a "political" brand—just as Roy Spence feared.

We were lightly regulated for a long time; now we have the SEC, OFHEO, and other governmental bodies essentially telling us, for the areas in their purview, how to operate. We will have to—and have started to—forge a new and constructive relationship with OFHEO. We will need to manage our regulatory affairs in the ordinary course--- not as an all hands on deck drill—and we have started to staff accordingly.

With respect to HUD, the rising tide of homeownership lifted all boats and made our affordable housing goals more of an exercise in analytics than on-the-ground

product and distribution actions. That has tightened in recent years, and we are in a transition from buying loans that are already in the market (e.g., bulk deals) to transformative strategies (ADC, inputting utility payments into credit scoring, Spanish language documents). At the right moment, we need to provide the organization with the license to switch many of the transformative initiatives we have discussed from "on hold" to "execute". You've been right all along—if it is ever perceived that we've missed fulfilling our mission, our support will evaporate. We have stopped short of crossing the Rubicon on many mission initiatives (sub prime, MLI 2.0, brokers, advertising, EASE, e-closing, Home Stay, Home Manager, Cash Resource, HELOC, risk linked notes, FHLB partnering, etc) due to political calculations or risk downsides that have not materialized. We've spent more time meeting to set goal target numbers to the last basis point than we have approving actual programs to deliver the loans. This is a flywheel that is slowing. Officer's guidance:

- Reset the OFHEO relationship on a sustainable, professional keel.
- Continue to prioritize and build exemplary SEC regulation.
- Recenter our brand and programs on Affordable Homeownership.

Competitive Environment

For years, our principal competitor was impaired by an antiseptic approach to the business and their customers, and more recently with accounting and management changes. Many of our longtime employees have never had a serious competitor—as you know, Freddie Mac has long been shorthand for "wrong". This is no longer true, and we face a resurgent competitor—courting Single Family customers, building a multifamily business and an HCD, recruiting our employees, and soon, operating with a "clean bill of health". While the FHLB future is less clear, they too will have a new and better future, in part because the very tendency of reform will cause them to become more like us in terms of structure and powers. As the flywheel slows, and political and resource constraints lock down new initiatives, we are in danger of losing our historic market leadership.

In addition, the size and growth of the market, and the availability of data and analytics (the creations of our own success) have enabled the success of a whole new class of competitors: private label securities and conduits in the Guarantee businesses; and depositories, hedge funds, pension funds, and even foreign investors in the Portfolio space. And the old reality—that we occupied the space and were essential to the intermediation between steady debt and messy MBS—has changed as well. The new reality is that our securities will have to stand on their own in the open market...sometimes against our very own debt.

At an even more fundamental level, the old reality was that our product, the fixed rate 30-year loan, was the object of desire, the preferred, high-end product of

most consumers. The new reality is that consumers do, in fact, want customization (again, our own creation), and they have learned how to tap the financial, not just the shelter, value in their homes. We've seen the ads for "floating rate, neg am, no dox" loans—a level of customization (if not imprudence) that would have been unimaginable just a few years ago. It may be Frankenstein, but we built it. One level up the food chain, seeing this new reality, customers like Countrywide want market share to be defined only against Freddie. We wish the reality were still built on the 30 year FRM; the new reality is built on the preferences on (now) educated consumers, for the product of their choosing, at their timing.

Finally, we may need to consider, a la Freddie Mac, a group or structure for an "integrated bid" to maximize the power and potential of Portfolio and Guarantee; just as consumers are demanding a best deal, our customers are looking for their best execution, without regard to where it comes from inside FannieMae. Officer's guidance:

- Get serious about Freddie Mac and the FHLB's; develop a strategy to keep private label in the rebar market.
- Learn to love (buy) ARM's.
- Manage and market MBS with the same vigor as we apply to debt.

Internally

We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us. We now operate in a world where we will have to be "normal". The SEC is our standard for disclosure and our arbiter for the rules, not our own proofreaders. We will soon have a new organization to establish and operate. We will spend the bulk of our focus next year building standards, routines and controls to be, in the new reality, "World Class". We have *worked* world class hard in the past, but the *output* was clearly not, in retrospect, world class. Your frustration with this—for example, the "adventure" of closing quarters--- has been expressed as "zero defects". As noted, this phrasing could create an anti-innovation, anti-risk mindset. Given the genetic proclivity of the company for risk aversion, I think you want to send a slightly different message; there are a few options, which go beyond phraseology to philosophy:

> "Execution Discipline": we might introduce a program of "Execution Discipline"--- within a new operations risk framework—including controllers, operations, compliance, development, market activities and risk management. The idea would be to put execution discipline on a par with risk discipline—a set of hard and fast rules about how we operate, how much deviation we will tolerate, what requirements must be in place to go into production (e.g., a pilot going into full production mode would

have to be placed in a "certified control environment" like Lewis' or Barbieri's shops).

Six Sigma: I have resisted the obvious temptation to commence a Six Sigma program during my time here, for a couple of reasons. First, the core of the program as practiced at GE was really about cost cutting--- replacing error-prone human processes with systems which by the way, happen to be cheaper. Putting processes into machines is something we're pretty good at. Obviously, there are other versions—Motorola, for example--- that are more about Quality. Second, the diversion of resources required to launch any Six Sigma program is phenomenal: staff has to be trained, the Audit staff reoriented, management has to go to school to get sufficient familiarity to manage projects, incentives must be put in place to convey the message that everyone is in the game. That said, FannieMae is a company that is very prone to SixSigma--- lot's of big, repetitive operations on many small items; statistically fluent managers; wide availability of data; alignment with customer processes like BofA SixSigma, and CHL's "Faster".

On the organizational side, the writing is on the wall for a new and significant CRO operation. Controller's will doubtless be split into planning and controlling entities. Reporting relationships will change. The Board will often be in what used to be the province of management. Bodies like SLT, Risk Management and OTI will have to adjust decision-making processes. In the ordinary course, HR is evolving; e-business is now big enough to clash with SF; we are grappling with how to build out our MBS group; overlaps increase between HCD and SF; most of the stability resides at the OOC. The market, regulators, the Board, and our own employees will demand greater transparency in our risk and financial measures. During the reset year, all of our officers and associates with have to constantly adapt to new reporting and operating structures, which will require new (and improved) behaviors.

Finally, on the personal side, as I have said, I don't know how you can walk upright in this free fire zone. The organization and the Board are clearly impressed and thankful. Our associates derive strength and hope from your demeanor. At the same time, many have gone to ground, refusing to make decisions, or engage on "dead elephants". I believe there is an opportunity here, not unlike the Maxwell "million dollar a day" era, to build a cohesive team, focus our purpose, and enshrine you as the legendary CEO who navigated through the transition, and held the team together (and set the stock price free).

- Decide on the right execution framework to eliminate extraordinary efforts, excessive workdays, and needless errors.
- Be prepared for operating and succeeding in a new organizational construct.

- Put your personal leadership on the line.

Tone

The tone of the meeting should be, "let's face the new reality as it is, not as we want it to be; let's do it as a team; and off hours, let's have some fun". The officers need to come out of the meeting having developed their own to-do lists, within the framework of a set of 2005 priorities (which in some sense serves as a short term strategy).

I think it is very important for you to be as explicit as possible in your remarks so that all the officers are writing down consistent "to do" lists. Bind them together. This is not as elegant as letting them noodle through the ideas and sift and sort their way to conclusions--- but I think they need to hear a new tone to understand that the message has changed. I also believe the tone has to be brutally honest to give them the air cover to talk about the elephants under the table, the new reality. Right now, from my direct discussions with them, many officers don't know what's on, and what's off the table. Can they make suggestions to improve the Controller's processes? Can they ask about the future prospects of the Portfolio? What about 2004 AIP? Did we finally decide whether MLI was a good thing or a bad thing? Who is going to resolve whether we should provide liquidity in the private label space?

During the 2005 transition period, we're prepared to spend $400 million not to let the flywheel stop:

1. Manage the business: adhere to risk disciplines, retain customers, execute flawlessly, and manage our people well.

2. Reset baselines: reset investors and employees to the new reality of market and stock growth; risk, reset the tone of our demeanor as a regulated company vis a vis OFHEO; rebuild relationships with friends and convert a few enemies (or at least catch them napping), reset our competitive strategy against many, capable organizations rather than one disabled opponent.

3. Build for the future: implement robust processes and controls, continue developing new products, bond teams together, expand the base of customers and partners. Invest in innovation and technology to be the leader and provider of the highest value-added relationship in industry.

4. Attract, retain and develop the best people in the industry.

This reset will create the foundation for an even Greater future: a strong organization with truly world-class controls; little slippage from the OFHEO

implementation; a company positioned in a key and growing market; with a management team that can capitalize on opportunities. It should also be clear that the reset is not a year off. It will be the toughest year in our history, but give us the opportunity to focus on building things that are in our control while certain other things (growth, capital, accounting) are somewhat out of our control.

Let me know if you want to discuss.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM JAMES B. LOCKHART III

Q.1. Former Federal Reserve Chairman Greenspan and Treasury Secretary Snow testified before this Committee about the need for GSE reform and specifically warned about the systemic risks posed by the GSEs' large portfolios that stand at about $1.5 trillion.

Given the level of fraud and mismanagement outlined in the recent OFHEO report on Fannie and a previous report on Freddie, how concerned are you about the ability of the GSEs to manage these large portfolios?

The Senate Banking Committee passed a GSE reform bill last July that gives the GSE regulator the ability to limit the portfolios based on their systemic risk and anchor them to their mission. Former OFHEO Director Armando Falcon recently wrote an op-ed arguing that this is critical authority the new regulator must have.

In your opinion, how critical is this authority?

A.1. First, as OFHEO's special examination reports on the two Enterprises and our most recent regular annual examination reports in our 2006 Report to Congress have made clear, both Enterprises have had and continue to face major controls and systems problems, areas critical to managing their very large asset portfolios. They each have literally years of work ahead of them to expand, strengthen, and rebuild the infrastructure they must have. Even after the Enterprises rectify their current unsatisfactory conditions, operational risks associated with their asset portfolios promise to remain considerable because of the size of the portfolios and the complexities of managing the interest rate risks involved.

Second, the interest rate and operational risks to the Enterprises created by the portfolios are accompanied by significant systemic risks affecting others. The Enterprises' size and importance to mortgage markets means that their problems could become broad housing finance issues. Their interdependencies with other institutions that hold their debt securities or are derivatives counterparties mean that that their problems could become broad financial market issues. Their high leverage and the lack of market discipline on their debt yields make their mortgage holdings more pre-

carious than for less leveraged firms subject to normal market discipline. In view of these risks, I think it is critical that the new regulator Congress creates for the Enterprises should receive guidance from Congress on what assets can be held by the Enterprises and the authority to set limits based on safety and soundness and systemic risk.

Reducing the portfolios will not, as some have claimed, cause mortgage market turmoil while just transferring the systemic risk elsewhere. Over the past 2 years, the Enterprises' agency mortgage-backed securities (MBS) portfolios shrank by more than $280 billion without market disruption. In many cases, investors replace Fannie Mae and Freddie Mac direct debt with higher yield MBS guaranteed by them. The new investors will generally be less leveraged than the Enterprises and often better able to take the risk of long-term mortgage assets, which might lessen the need to utilize the derivative markets, as well.

Q.2. The OFHEO report states that "by deliberately and intentionally manipulating accounting to hit earnings targets, [Fannie's] senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders."

Specifically, which senior management benefited from these bonuses? How much did they make? Is OFHEO going to ask that this money be returned?

Who specifically directed the accounting manipulation? Who was aware of it? What was the specific role of then Chief Operating Officer Daniel Mudd, former Chief Executive Officer Franklin Raines and former Chief Financial Officer Timothy Howard?

A.2. As described in Chapter V of our report, Fannie Mae employees at and above the level of Director (here, Director being a managerial level below Vice President, not a member of the Board) participated in the Annual Incentive Plan (AIP), which was directly tied to growth in earnings per share (EPS). For the years 1998–2001, the range of funding of the AIP bonus was 50 percent of a target amount for minimum corporate EPS achievement to 150 percent of a target amount for maximum achievement. Beginning in 2002, the Board tightened the funding range to 75 percent for minimum achievement of EPS goals and 125 percent for maximum achievement. By 2002, AIP bonus award eligibility included the Chief Executive Officer (CEO), two Vice-Chairs, six Executive Vice Presidents, 35 Senior Vice Presidents, 117 Vice Presidents, and 495 Directors.

In addition to AIP, senior executives benefited from the Performance Share Plan (PSP), which included financial goals tied directly to EPS on a rolling 3-year basis. On top of this, virtually all employees were awarded "EPS Challenge Grants," the award of which was based upon doubling EPS from $3.23 at the end of 1998 to $6.46 at the end of 2003.

Shown below is a table from our report showing the compensation of the five highest-paid Fannie Mae executives from 1998 through 2003. Note that the compensation shown for bonus, PSP, and the EPS Grants was directly tied to EPS goals.

	1998	1999	2000	2001	2002	2003	*Totals*
Franklin Raines							
Salary	$526,154	$945,000	$992,250	$992,250	$992,250	$992,250	*$5,440,154*
Bonus	1,109,589	1,890,000	2,480,625	3,125,650	3,300,000	4,180,365	*$16,086,229*
PSP	794,873	1,329,448	4,588,616	6,803,068	7,233,679	11,621,280	*$32,370,964*
Options	4,052,484	4,358,406	5,829,071	7,945,648	6,680,395	3,006,895	*$31,872,899*
EPS Grant						4,358,515	*$4,358,515*
Total	$6,483,100	$8,522,854	$13,890,562	$18,866,616	$18,206,324	$24,159,305	***$90,128,761***
Timothy Howard							
Salary	$395,000	$414,800	$435,540	$463,315	$498,614	$645,865	*$2,853,134*
Bonus	493,750	518,500	544,425	694,983	781,250	1,176,145	*$4,209,053*
PSP	909,196	860,464	2,088,542	1,987,119	1,947,368	3,470,578	*$11,263,267*
Options	938,912	1,154,593	2,035,589	2,166,427	1,749,995	2,491,974	*$10,537,490*
EPS Grant						1,292,085	*$1,292,085*
Total	$2,736,858	$2,948,357	$5,104,096	$5,311,844	$4,977,227	$9,046,647	***$30,155,029***
Jamie Gorelick							
Salary	$567,000	$595,400	$625,170	$656,429	$689,124	n/a	*$3,133,123*
Bonus	779,625	818,675	859,609	1,083,109	911,250	n/a	*$4,452,268*
PSP	1,055,217	1,292,693	2,458,528	2,591,060	3,049,012	n/a	*$10,446,510*
Options	1,444,397	1,975,501	2,516,927	2,498,108	n/a	n/a	*$8,434,933*
EPS Grant							
Total	$3,846,239	$4,682,269	$6,460,234	$6,828,706	$4,649,386		***$26,466,834***
Daniel Mudd							
Salary	n/a	n/a	$537,063	$656,429	$689,124	$714,063	*$2,596,679*
Bonus	n/a	n/a	735,130	1,083,109	911,250	1,288,189	*$4,017,678*
PSP	n/a	n/a	414,090	1,188,846	2,339,702	4,674,015	*$8,616,653*
Options	n/a	n/a	2,516,927	2,498,108	1,776,933	2,355,030	*$9,146,998*
EPS Grant						1,928,049	*$1,928,049*
Total			$4,203,210	$5,426,492	$5,717,009	$10,959,346	***$26,306,057***
Robert Levin							
Salary	$395,000	$414,800	$435,540	$457,317	$480,092	$576,706	*$2,759,455*
Bonus	493,750	518,500	544,425	686,028	575,000	801,237	*$3,618,940*
PSP	909,196	860,464	2,088,542	1,987,119	1,947,368	2,706,381	*$10,499,070*
Options	938,912	1,154,593	1,218,212	1,281,658	1,552,496	2,240,652	*$8,386,523*
EPS Grant						1,154,635	*$1,154,635*
Total	*$2,736,858*	*$2,948,357*	*$4,286,719*	*$4,412,122*	*$4,554,956*	*$7,479,611*	***$26,418,623***

In the consent order executed by Fannie Mae and accepted by the Director of OFHEO on May 23, 2006, the Enterprise agreed to conduct reviews of current employees, as well as Board members, mentioned in the OFHEO report. The report based on this review will include the Enterprise's plans to seek restitution, disgorgement, or other remedies to recover funds from individuals. OFHEO will review this report and take enforcement actions, if necessary, with respect to these matters. As part of the consent order, Fannie Mae has agreed to review the possibility of pursuing former executives to disgorge their bonuses.

The Report of the Special Examination of Fannie Mae cites instances where management directed accounting decisions that did not comply with GAAP and that allowed management to maximize their bonus compensation. For example, in January 1999, Chairman and CEO Franklin Raines approved a recommendation made by the Chief Financial Officer (CFO) (Tim Howard) and the Controller (Leanne Spencer) to defer the recognition of $200 million in amortization expense. This deferral, along with other accounting decisions made at that time relating to provisions for loan losses

and the recognition of low-income housing tax credits, allowed management to meet the EPS threshold for maximum bonuses.

In addition to Fannie Mae management, personnel from KPMG, including Julie Theobald, Ken Russell, and Eric Smith, were aware in January 1999 that amortization expense was understated by about $200 million. KPMG posted an audit difference for that amount, but then waived it, stating that it was immaterial. However, the expense deferral was material, as it allowed management to meet its 1998 earnings targets and achieve maximum AIP bonus payouts.

Ms. Theobald told OFHEO examiners that the $200 million expense deferral was disclosed to Audit Committee Chair Thomas Gerrity, but this was done in early February 1999—more than 2 weeks after Fannie Mae's mid-January public release of its 1998 earnings. The appropriate time for KPMG to advise Gerrity about the expense deferral would have been before the 1998 earnings release.

The desire to minimize earnings volatility was well known throughout the ranks of senior management. For example, in a November 4, 2001, memorandum from Ms. Spencer to Mr. Raines entitled "Update on Earnings," Ms. Spencer provided information on earnings management and "smoothing ideas." Ms. Spencer also described to Mr. Raines plans to "pull the earnings down" to $6.30 EPS in the following year (2002), with an indication that CFO Howard had asked the Senior Vice President for Portfolio Strategy, Peter Niculescu, for ideas on how to accomplish that. In part, this strategy to push earnings out of 2002 to future periods was accomplished through the use of income-shifting REMICs, which had no substantive economic purpose, but which altered the recognition of book income, allowing management to smooth earnings. This strategy to shift income was presented in a November 2001 Quarterly Business Review, which was attended by Messrs. Raines, Mudd, and Howard, among others.

The process used by Fannie Mae for amortizing deferred premiums and discounts relating to mortgages and MBS was a key component of the earnings management process. Had management complied with SFAS 91, which prescribes the rules for these activities, Fannie Mae would have recognized significantly more earnings volatility than they actually did. A former employee of Fannie Mae, Roger Barnes, alerted management to significant accounting and control problems relating to amortization, including Messrs. Raines and Howard, as well as the head of the Office of Auditing (Sam Rajappa) and management in the Controller's Office, including Leanne Spencer, Janet Pennewell, and Mary Lewers. Problems with Fannie Mae's amortization accounting were also raised by Michelle Skinner in an informal employee meeting chaired by Daniel Mudd, who was then Chief Operating Officer. As the OFHEO Report describes, Mr. Mudd failed to adequately follow-up on the concerns raised by Ms. Skinner.

Q.3. The OFHEO report states that Fannie Mae lobbyists "worked to ensure that the agency (OFHEO) was poorly funded" and "used longstanding relationships with Congressional staff . . . to interfere with OFHEO's special examination" of Fannie Mae.

Specifically, explain this in more detail. How did Fannie lobbyists interfere with your investigation?

Please comment on Fannie's lobbying effort to generate the HUD Inspector General's fourth investigation of OFHEO.

Who specifically directed Fannie Mae lobbyists to do this? Who specifically was aware of this? What was the role of Mudd, Raines, and Howard?

Your report states the Board was notified by a Fannie employee of the HUD Inspector General's results. What was the Board's role in all of this? Were they aware of what was going on? Why were they notified?

A.3. The aggressive policy of Fannie Mae toward its regulator was, in part, developed by its Government and Industry Relations unit, which was led by Thomas Donilon and involved Government and Industry Relations employees, William Maloni and Duane Duncan, during the period reviewed for the Special Examination. What began as aggressive lobbying later became a systematic attempt to undermine the work of the Special Examination. This strategy manifested itself in several ways:

1. Working with Senate Appropriations staff, Fannie Mae sought to attack former OFHEO Director Falcon and the agency through the generation of a Department of Housing and Urban Development (HUD) Inspector General (IG) examination investigating travel and employee salaries in the OFHEO legislative/external office. An e-mail from Duane Duncan to Donilon dated October 27, 2002, describes these efforts. It is noteworthy that OFHEO was not asked for this information directly. Evidence discovered during the exam shows a company policy of generating HUD IG investigations, with the implication of possible wrongdoing, in an effort to undermine the reputation and credibility of the agency.
2. Documentary evidence demonstrates continuous efforts between Fannie Mae and congressional staff to establish percentage guidelines to govern agency use of appropriated funds, which was seen as a way to divert funds from the Special Examination.
3. Working with staff of the VA-HUD Subcommittee of the Appropriations Committee of the U.S. Senate, Fannie Mae was able to get language inserted into an appropriations bill that would have withheld $10 million from OFHEO appropriations until a new director was appointed to replace Armando Falcon, who, as the Director of OFHEO, initiated the Special Examination of Fannie Mae.
4. A fourth effort, resulting from extensive interaction between a Fannie Mae lobbyist and congressional staff, was the initiation of a HUD IG examination to determine if OFHEO was spending an appropriate percentage of its budget on examinations. The HUD IG concluded that OFHEO met the appropriate requirements and was comparable to other Federal financial regulators in its allocation of funds and staff. However, key OFHEO resources were diverted for almost 10 months while complying with the requirements of the examination.

5. Again, working with congressional staff, Fannie Mae lobbyists succeeded in initiating another HUD IG examination (the "fourth") to investigate whether the leadership of OFHEO had, as part of their personal political agenda, overstated accounting problems of Fannie Mae. In sworn testimony, Duane Duncan, head of Government and Industry Relations at Fannie Mae, admitted that Fannie Mae had initiated the HUD IG examination in an effort order to discredit the findings of the Special Examination and the agency.

In a sworn interview with OFHEO examiners, Duane Duncan testified that it was the desire of Fannie Mae senior management that the report of the HUD IG's fourth investigation to discredit the agency and Special Examination be made public. Mr. Duncan received direction from his superiors during meetings of the External Affairs Committee, which met each Monday. Franklin Raines, Thomas Donilon, Timothy Howard, and sometimes Daniel Mudd attended those meetings, with Mr. Raines and Mr. Donilon deciding what positions Fannie Mae would take on any given issue. Mr. Duncan implemented the decisions made at those meetings. Mr. Duncan also met with Mr. Donilon at the end of each workday in order for Mr. Donilon to manage the implementation of the decisions.

The management of Fannie Mae wanted the report of the HUD IG's investigation published, even though it was nonpublic and legally restricted information. Accordingly, the Enterprise began a campaign to enlist support for the release of the report. Fannie Mae eventually succeeded in getting the document published on a congressional Web site for 1 hour, during which time management downloaded the report for further dissemination, including to its Board of Directors, analysts, and congressional staff. Thus, management succeeded in its efforts to distract attention from its multi-billion dollar accounting errors by creating a large volume of publicity about OFHEO.

In an interview with lawyers from Paul, Weiss (counsel to the Board of Directors), Ken Duberstein, a director on the Board of Fannie Mae, said that he recalled Mr. Raines saying that the HUD IG report would undermine OFHEO and that Mr. Raines could obtain an early release copy of the report. According to Mr. Duberstein, he told Mr. Raines that such an approach could backfire and that Mr. Raines should stay away from any such approaches.

Q.4. The OFHEO report states that the:

> Board contributed to those problems by failing to be sufficiently informed and to act independently of its chairman, Franklin Raines, and other senior executives; by failing to exercise the requisite oversight over the Enterprise's operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices.
>
> The Board's failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high profile firms, the initiation of OFHEO's special examination, and credible alle-

gations of improper earnings management made by an employee of the Enterprise's Office of the Controller.

Can you give specific examples of the Board's failures? Explain also the "credible allegations of improper earnings management" made by a Fannie employee.

A.4. The Fannie Mae Board of Directors failed in numerous ways that put the safety and soundness of the Enterprise at risk. Among other things, the Board:

- Failed to stay informed about Fannie Mae corporate strategy, major plans of action, and risk policy;
- Approved an executive compensation program that created incentives to manipulate earnings;
- Failed to provide delegations of authority to management that reflected the current size and complexity of the Enterprise;
- Failed to ensure the effective operation of its own Audit and Compensation Committees;
- Failed to act as a check on the authority of Chairman and CEO Franklin Raines;
- Failed to initiate an independent inquiry into Fannie Mae's accounting following the announcement of Freddie Mac's restatement and subsequent investigation; and
- Failed to properly look into the allegations of Roger Barnes.

In August 2003, Roger Barnes, a former Manager in Fannie Mae's Controllers' Office, approached the Office of Auditing to raise concerns regarding Fannie Mae's accounting practices related to SFAS 91. By that time, the Baker Botts report had been released detailing accounting manipulations at Freddie Mac. OFHEO had also announced plans to commence a special investigation of Fannie Mae's accounting practices. Against that backdrop, Mr. Barnes questioned the propriety of amortization accounting, and asserted his belief that amortization amounts recorded in the financial statements were manipulated in order for them to "agree" with forecasted amortization expenses. Such actions would constitute inappropriate earnings management. The Office of Auditing was responsible for investigating those allegations. In the September 2004 Report of Findings to Date, Special Examination of Fannie Mae, OFHEO found that the Office conducted a hurried investigation into Mr. Barnes' allegations that culminated in the head of the Office of Auditing certifying GAAP compliance to the Board of Directors.

Fannie Mae rushed into a severance agreement with Mr. Barnes on November 3, 2003. Given its responsibilities for regulatory compliance and investigation of complaints related to accounting, internal controls, and auditing matters, the Audit Committee was required to ensure a timely, thorough, and independent investigation into Mr. Barnes' allegations. The allegations, and subsequent settlement agreement, should have raised the concern of every member of the Audit Committee, especially when considered against the background of the recently released Baker Botts report on Freddie Mac's internal investigation and the initiation of the OFHEO Special Examination.

The Audit Committee failed to make further inquiries or convene a special investigation after being informed at the November 17,

2003, Audit Committee meeting that Fannie Mae had reached a settlement with Mr. Barnes. The news of the settlement was received by the Audit Committee just 3 days after the Committee had been convened in order to discuss certification of the third quarter financial statements. Fannie Mae settled the case before bringing the matter to the Audit Committee and elected to postpone discussion of the matter until after the financial statements had been certified. Given that OFHEO had just announced a Special Examination of Fannie Mae's accounting practices, the allegations made by Mr. Barnes warranted further investigation. At a minimum, the Audit Committee had an obligation to ensure that the matter be disclosed to OFHEO. Instead, the matter was ignored until February 2004, when it was reviewed as part of the Special Examination.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JAMES B. LOCKHART III

Q.1. Fannie Mae signed a consent agreement on May 23, 2006, with the Office of Federal Housing Enterprise Oversight agreeing to cap its retained mortgage related portfolio to $727 billion, its level on December 31, 2005.

Using Fannie Mae's $727 billion portfolio as a model, what would Fannie Mae's portfolio size be with the limits of S. 190? Please include an explanation of the assumptions that you used to arrive at this number?

A.1. S. 190 would restrict mortgage and mortgage securities to those held for the purpose of securitization, those that are not readily securitized, and those held solely for the purpose of supporting the guarantee business. More than half of Fannie Mae's mortgage asset portfolio at the end of last year comprised securities already guaranteed by Fannie Mae, or by Freddie Mac or Ginnie Mae. Those would not generally be permitted. The remaining $355 billion is roughly divided between private label MBS (11 percent) and whole mortgages (35 percent), and a large portion do not qualify under HUD's rules as supporting affordable housing. More work would be necessary to determine how much would be permitted under S. 190, but a strict reading of the language might qualify only a small portion.

Q.2. What are the public policy benefits and risks of the two different portfolio sizes?

A.2. Enterprise asset portfolios can contribute to the availability of funding for affordable housing and to the stability and liquidity of the secondary market for mortgages and the market for mortgage securities. These benefits, however, could still be achieved with much smaller portfolios, while risks would be greatly reduced.

The major portion of the Enterprises' public policy benefits stem from their guarantee business. By guaranteeing securities backed by pools of mortgages, they make use of their GSE status to make mortgage investments more desirable to a wider range of investors. That lowers mortgage interest rates on conforming loans, with estimates of the effects ranging from 2 to 25 basis points. Purchasing mortgage securities for their asset portfolios has little effect, in

general, because it simply substitutes one type of debt for another, with Enterprise borrowings replacing mortgages and MBS. This is especially true when an Enterprise acquires mortgage securities already guaranteed by an Enterprise. Much the same is true when an Enterprise buys and holds mortgage loans that it could easily securitize. However, the Enterprises also buy mortgages and hold them for a short time while they are securitizing them.

Assessing the effects of the remainder is more complex because Enterprise acquisition of these assets not only withdraws them from the debt market, but it also replaces them with Enterprise debt. This category includes Enterprise purchases of private label securities backed by subprime loans, manufactured housing, and municipal revenue bonds. The magnitude of benefits for loans in these categories is uncertain, as is the extent to which they could be maintained if the Enterprises did not retain the securities on their balance sheets, but instead guaranteed the securities and resold them. As for stability and liquidity, an active trading capability coupled with a small inventory of securities backed by the ability to expand rapidly to cope with market liquidity emergencies should serve those purposes.

While the benefits of the Enterprises' large asset portfolios are limited, the risks are quite significant. Mortgages, especially fixed-rate mortgages, have complex and difficult to anticipate payment patterns requiring extensive hedging activities. The interest rate risk in its portfolio caused massive losses to Fannie Mae in the early 1980s and more recently in 2002, and the operational risk in their portfolios has caused serious problems for both Enterprises in recent years. Because of their size and importance to housing finance markets, counterparties, and holders of their securities; and because of their high leverage ratios, the lack of market discipline, and lack of bankruptcy or receivership provisions, these institutions also entail significant systemic risk that stems to a large degree from their asset portfolios. Weighing the benefits and the risks, it seems clear that Enterprise mortgage portfolios should be much smaller without affecting their missions of affordable housing, stability, and liquidity.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM JAMES B. LOCKHART III

Q.1. In your testimony today you stated that the OFHEO report details an arrogant and unethical corporate culture at Fannie Mae from 1998 to 2004. You also stated that, "perhaps the best written record of this culture is a memo from the Chief Operating Officer Dan Mudd to the CEO 2 months after OFHEO's interim report." In that memo Mr. Mudd was discussing the need to change and wrote:

> The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition . . . We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us. We now operate in a world where we will have to be 'normal.'

Given your selections of this memo as the best example of what went wrong at Fannie Mae, to what degree was Dan Mudd responsible for what happened at Fannie Mae? How should he be held accountable?

A.1. Mr. Mudd was Chief Operating Officer at Fannie Mae from February 2000 through December 2004, when he was elevated to CEO upon the resignation of Mr. Raines. Mr. Mudd, in addition to broad responsibilities for ensuring that Fannie Mae had an adequate operating infrastructure, also had responsibilities to monitor the profit and loss statements of the business units reporting to him. We now know through the Special Examination that the accounting policies used by these business units were seriously deficient, particularly as they relate to the impairment of mortgage assets. The finite insurance transactions discussed in our report, which involved little or no transfer of risk, affected business units reporting to Mr. Mudd. Mr. Mudd also chaired Quarterly Business Review meetings, during which senior executives sometimes presented strategies relating to income shifting.

Given these circumstances, plus the problems noted in our report regarding the lack of appropriate action by Mr. Mudd when accounting concerns were raised to him by Michelle Skinner, we think it is appropriate for the Board to include Mr. Mudd in its review of current employees with respect to possible disgorgement of compensation. OFHEO will assess the results of the Board's review upon completion.

Q.2. How confident are you with Fannie (and Freddie's) most current financial reporting? When will each company complete their accounting restatements?

A.2. OFHEO is not satisfied with the Enterprises' current reporting given the control weaknesses that have been found to date. Both companies are devoting significant resources to improve their financial reporting capabilities and they are making progress toward having audited financial statements. Much work and testing remains to be done.

OFHEO and the Enterprises' external auditors are engaged and are carefully monitoring the remediation of the financial reporting process. Both Enterprises are implementing major new systems and processes to facilitate more timely and accurate financial reporting. OFHEO must remain vigilant as the introduction of new systems, processes and personnel can initially increase the risk of operational errors.

Currently Freddie Mac has completed its financial restatement, however they have not yet returned to timely financial reporting. Their objective is to return to quarterly reporting with the release of full-year 2006 financial results. After that, they will begin the process of registering their common stock with the SEC. Fannie Mae is still in the process of completing its financial restatement for the years 2002–2004, and they expect to be complete by the end of 2006.

Q.3. Fannie is required to continue maintaining a 30 percent capital surplus, as part of its capital restoration plan. Under what conditions may you decide that this requirement should be modified or expire?

A.3. The 30 percent capital surplus is required due to operational weaknesses at Fannie Mae, including accounting and internal control deficiencies. Until such weaknesses are demonstratively corrected to OFHEO's satisfaction, and assuming no other safety and soundness issues emerge, the surplus will stay in place. OFHEO evaluates capital on an ongoing basis, assessing existing and emerging issues, to determine the adequacy of Fannie Mae's capital. At this time, it is therefore not possible to predict when the capital surplus requirement may be modified. As you know, the pending legislation gives OFHEO more flexibility in setting both minimum capital and risk-based capital requirements. Operational risk will be a component of each.

Q.4. Fannie Mae is required to report to you whether any former officers should be terminated. What action could OFHEO take against these individuals.

A.4. Fannie Mae must report to OFHEO whether the company will seek damages or other remedies against former officers. If the company fails to taken action, OFHEO has available, under a 2-year statute of limitations, the ability to seek restitution, disgorgement, or reimbursement of such individuals as well as civil money penalties that could exceed any actual damages. As noted in comments transmitted to the Banking Committee on the legislation, the procedures for (and, thereby, the effectiveness of) OFHEO's current remedies would be improved by the pending legislation.

Q.5. Freddie Mac has announced that its accounting restatement will be further delayed. What is the status of Freddie Mac's compliance with its written agreement with OFHEO and the company's outlook from your standpoint?

A.5. As noted previously, Freddie Mac now has completed its financial restatement, but is not yet a timely filer of financial statements. The Enterprise is currently in compliance with the Agreement, and they continue to work to improve their governance and operational issues. Specific plans has been executed by the Enterprise but it may take several years to implement them.

Q.6. The Chairman of the Board and CEO positions, held jointly by Franklin Raines, have been separated and Chairman Stephen Ashley appears to have cast the nonexecutive chairman roll as an independent check on the CEO. What are the benefits of those changes in structure and practices and what is your assessment of Ashley's performance?

A.6. OFHEO determined that in the instance of both Fannie Mae and Freddie Mac the position of Chairman of the Board and CEO should be separated. This has been effectuated with Fannie Mae and we are working with Freddie Mac to do the same. Such separation of positions has been adopted by a growing number of public companies. The Enterprises hold unique positions, including a public mission, and the need for Board oversight of that mission is enhanced with separation of the two positions. Further, where both companies need to focus their energies on remediation—a primary responsibility of management—the separation permits a more efficient use of personnel.

Q.7. The report states "the goal of senior management was straightforward: to force OFHEO to rely on the Enterprise for information and expertise to such a degree that Fannie Mae would essentially regulate itself." Would you agree that Fannie Mae sought to oversee OFHEO, instead of the other way around?

A.7. As a matter of corporate policy, Fannie Mae sought to circumvent, constrain, and undercut OFHEO. Some of the techniques used by Fannie Mae included personal attacks on the competence, integrity, and motivation of officers at the agency, limiting the budget of the agency through the appropriations process, and creating conflicts with other independent and executive branch regulatory agencies. Further, after the initiation of the Special Examination, Fannie Mae undertook a concerted effort to limit and interfere with the examination by working with legislators and their staff to generate repeated IG investigations. This was done in order to divert agency resources and attention away from the Special Examination, to disparage the agency and its officers, and to restrict the use of appropriated funds.

Q.8. Were efforts to generate interagency conflict, between OFHEO and HUD, SEC, OMB, and others, made at Fannie Mae's highest levels, and if so by whom?

A.8. The practice of opposing, circumscribing, and constraining its regulator became a firmly established practice at Fannie Mae. One method Fannie Mae employed to accomplish this involved creating conflict between OFHEO and other agencies whenever OFHEO attempted to craft regulations or take other regulatory actions. For example, correspondence between Fannie Mae's outside counsel (WilmerHale) and Ann Kappler, who was Fannie Mae's General Counsel at the time, reveal efforts to contact the Secretary of HUD and the HUD General Counsel in order to convince them of a "legal flaw" in the then-proposed OFHEO risk-based capital rule, which then would provide justification to "kick the legal issue to Justice for resolution." This would allow the dispute to be seen as one between OFHEO and another regulatory agency, not between Fannie Mae and its regulator.

Other correspondence reveal efforts on the part of Fannie Mae to scuttle OFHEO's then-proposed corporate governance regulations by supporting arguments that the SEC and the Stock Exchanges—not OFHEO—had the legal authority to do rulemaking in this area. Further, when the OFHEO Special Examination of Fannie Mae commenced, correspondence describes a call to the General Counsel of the SEC from Fannie Mae's General Counsel, who stated that "We do not believe that OFHEO has authority to opine on GAAP, or to order us to restate our financial statements. We would like to reach an understanding with the Commission on this matter."

Q.9. It is my understanding that the size and aggressiveness of the company's lobbying and grass roots activities have been substantially reduced. Can you give me more specifics about in-house and external activities in terms of personnel, costs, and approach?

A.9. Fannie Mae, in the consent order issued by OFHEO, is required to conduct a review of and develop enhanced internal controls for the operation of the Government and Industry Relations office. The purpose is to have adequate supervision in place to as-

sure control by the Enterprise of this operation such that the mission and positions taken by the Enterprise are subject to control and review. As part of the review, we will secure information on expenses, broadly defined, as well as costs and controls.

Q.10. Did you evaluate the role of Fannie Mae's Community Business Centers, formerly known as Partnership Offices, in community or political activities?

A.10. Fannie Mae CEO Daniel Mudd announced changes to the partnership offices and changes to the name, mission, and role in political matters. OFHEO will be examining these functions and will be able to provide additional information. By way of background, I would note the following points.

Although an evaluation of the Partnership Offices was not a primary focus of the Special Examination, many of the documents that we reviewed indicate that a primary factor in deciding where Partnership Offices would be located was the perceived need to build relationships with key Members of Congress. Rob Levin, currently Executive Vice President and Chief Business Officer of Fannie Mae, testified to the nature of so-called "affinity" contacts in particular Partnership Offices, and that Fannie Mae staff would be "aware of" relationships with Members of Congress and other government officials when making decisions regarding Partnership Offices.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM CHRISTOPHER COX

Q.1. In your testimony, you note that you have encouraged the New York Stock Exchange (NYSE) to amend its rule, which exempted Fannie Mae from having to delist from the NYSE, by putting an expiration date on this exemption.

Can you comment as to specifically when this expiration date is? What is the status and timetable of Fannie's restatement and registration with the SEC? When will Fannie be in total compliance with its financial disclosure?

Just to be clear, my understanding is that if Fannie does not meet any part of this timetable, then the SEC will ensure that the listing rules are enforced and no further special exemptions are granted. Is this correct?

For that matter, what is the status of Freddie's registration? When will Freddie be in total compliance with its financial disclosures?

A.1. On January 30, 2007, Commission staff, acting pursuant to delegated authority, approved a proposed rule change (attached and available at: *http://www.scc.uovlrulcs/sro/nvsc/2007/34–55198.pdf*) by the NYSE to eliminate a provision of NYSE Rule 802.01E, which operated to permit Fannie Mae to continue listing on the NYSE even though it was more than 12 months late in filing its annual report. Under the NYSE's rule change, the Exchange's discretion to allow a company to continue listing that is more than 12 months late shall expire on December 31, 2007. The NYSE's rule change also provides that if prior to December 31, 2007, the Exchange had determined to continue listing a company

that was more than 12 months late pursuant to that provision of Rule 802.01E, and that company fails to file its late annual report by December 31, 2007, suspension and delisting procedures will commence in accordance with the NYSE's Listed Company Manual.

Fannie Mae filed its 2004 Annual Report on Form 10-K with the Commission on December 6, 2006. The filing provides consolidated financial statements for 2004, and a restatement of previously issued financial information for years 2002, 2003, and the first two quarters of 2004.

Although Freddie Mac agreed to voluntarily register under the Exchange Act, it has not yet formally filed a registration statement with the Commission. Freddie Mac has stated it intends to complete the Exchange Act registration process when it completes its restatement and audit of its financial statements.

Freddie Mac has publicly indicated its accounting and disclosure practices are the subject of a pending investigation by the Commission's Enforcement Division.

Q.2. In your testimony, you note that "the Commission—going at least as far back as 1992—has consistently advocated the view that, because GSEs sell securities to the public, have public investors, and do not have the 'full faith and credit' government backing of government securities, GSE disclosures should comply with the disclosure requirements of the Federal securities laws."

In your opinion, should Fannie and Freddie be required to register their debt and mortgage backed securities with the SEC (not just their common stock) as well? Why should Fannie and Freddie get a free pass when other companies don't? What's wrong with more disclosure?

Wouldn't this requirement send a clear message to the markets that GSE debt is not backed by the full faith and credit of the Federal Government? Wouldn't this be good public policy for the American taxpayer?

A.2. The Commission participated with the Department of Treasury and the Board of Governors of the Federal Reserve System in a 1992 Joint Report on the Government Securities Market (1992 Report) that addressed these issues, among other things.[1]

As an introductory matter, please note that the two Federal securities laws that are relevant to the question—the Securities Exchange Act of 1934 and the Securities Act of 1933—have very different, though related, purposes.

- The Exchange Act requires registration of various categories of public securities. Exchange Act registration results in ongoing periodic reporting of detailed narrative and financial disclosure regarding the corporation. This corporate information is the information on which the Commission and staff have focused in urging disclosure by GSEs. Registration under the Exchange Act also subjects reporting companies to the provisions of the Sarbanes-Oxley Act applicable to Issuers.
- The Securities Act requires registration of transactions, namely public offerings of securities. In addition to information

[1] Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, *Joint Report on the Government Securities Market,* January 1992.

about the securities being offered, registration under the Securities Act requires disclosure of essentially the same corporate information as is required under the Exchange Act. Commission staff review of Securities Act registration statements may affect the timing of securities offerings and other registered transactions.

The 1992 Report did not recommend removal of the exemption from the Securities Act for the offer and sale of mortgage-backed and related securities of Fannie Mae and Freddie Mac as it is not clear what impact registration and reporting of mortgage-backed offerings might have had on the secondary mortgage market.

In 2002, staff of the Commission, Department of Treasury, and OFHEO conducted a joint study of disclosure regarding mortgage-backed securities with a view to ensuring that investors in mortgage-backed securities are provided with the information that they should have.[2] The report, which was issued in January 2003 concluded that some additional disclosures would be both useful and feasible in the mortgage-backed securities market. Each of Fannie Mae and Freddie Mac has implemented these new disclosures.

Consideration of Securities Act registration of the GSE's mortgage-backed and related securities raises a very significant and unique complexity, as discussed in the January 2003 report, due to the fact that a substantial portion, recently a majority, of the GSE's mortgage backed securities have been issued in the so-called "To Be Announced," or "TBA," market. We understand that the TBA market is significant, as it is used to set or "lock in" mortgage rates in the U.S. housing market. Transactions in this market involve forward sales of pools of mortgages that are not yet identified and, in most cases, are not yet in existence. Because actual pools are not established at the time of the transactions, there can be no disclosure of pool characteristics beyond the TBA standards already available to the market. Therefore, the registration of offers and sale of mortgage-backed securities would necessitate a consideration of the impact of such registration on TBA transactions.

Finally, the matter of requiring the registration of Fannie Mae's and Freddie Mac's mortgage-backed and related securities should be considered in light of that registration's likely impact on other GSEs that are exempt from the Federal securities laws. For example, the Federal Home Loan Bank System, which was created prior to enactment of the Securities Act or creation of the Securities and Exchange Commission in 1934, is comprised of twelve banks that are GSEs and operate independently. The Federal Home Loan Bank System, through the Office of Finance, is one of the largest issuers of debt securities in the world and the Federal Home Loan Banks compete with Fannie Mae and Freddie Mac for debt investors. While the Finance Board adopted a rule requiring Exchange Act registration of the common stock of each Bank and almost all of the Banks have now completed that registration, the Banks continue to be exempt from the Securities Act and the other Federal securities laws.

[2] Department of Treasury, Office of Federal Housing Enterprise Oversight, Securities and Exchange Commission, *Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Market,* January 2003.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM CHRISTOPHER COX

Q.1. What is your estimate of the loss to shareholders created by the accounting scandal documented in the OFHEO Report? Some estimates are that there have been $1.3 billion in expenses related to correcting the accounting fraud not to mention the billions in market losses?

A.1. The Commission's Office of Economic Analysis (OEA) estimates that the fraud at Fannie Mae caused its common stock to be overvalued by an amount ranging from $12.5 billion to $16.5 billion. This estimate is based on OEA's determination that Fannie Mae's stock declined by about 25 percent as the news of the fraud became public over the course of more than a year. As news of the fraud became public, the market realized that not only was Fannie Mae very different from what it represented itself to be, but also that Fannie would have to spend a considerable amount correcting the accounting fraud. Thus the $12.5 to $16.5 billion figure includes the market's expectation of the cost of correcting the accounting fraud at the time it was revealed.

Shareholders who bought their stock after the fraud began and held onto it as the fraud was revealed very likely lost money as the stock fell. Because Fannie Mae's stock was heavily traded during the lengthy period of the fraud, it would have been extremely difficult to calculate such trading losses with precision, and doing so would have consumed extraordinary resources.

Instead, the Commission's OEA staff examined Fannie Mae's offerings of securities during the fraud period to determine whether Fannie Mae derived an improper benefit from its financial fraud. OEA determined that the prices of the debt securities sold by Fannie during the fraud period were not inflated. However, OEA found that the fraud nevertheless benefited Fannie Mae by allowing it to meet its minimum capital requirements with less capital than was required under Generally Accepted Accounting Principles and applicable law. This improper benefit allowed Fannie Mae to operate on a larger scale than it was entitled to operate, allowing it to generate larger profits than it was entitled to generate.

Q.2. How did you determine the $350 million fine for Fannie Mae, and do you believe that figure even approaches full restitution for shareholders?

A.2. In determining the fine in the Fannie Mae case, the Commission applied the principles set forth in its statement on financial penalties issued in January 2006. That statement sets forth nine factors that the staff should consider in evaluating the appropriateness of financial penalties.

In applying these factors, the Commission consults with, among others, the professional staff in its Office of Economic Analysis (OEA). OEA is particularly helpful in determining whether the corporation derived a direct benefit as a result of the violation, which is one of the primary factors in the Commission's penalties statement.

In this case, OEA determined that, but for the fraud, Fannie Mae would not have met the minimum capital requirements set for it by its primary regulator, the Office of Federal Housing Enterprise

Oversight. In other words, the fraudulent accounting allowed Fannie Mae to operate on a larger scale—and therefore to earn larger profits—than it would have been able to do if it had complied with Generally Accepted Accounting Principles and applicable law. Using a conservative analysis, OEA determined that Fannie Mae's misconduct allowed it to derive an overall illicit benefit that was likely at least $400 million.

Based on this analysis of benefit, the other factors in the Commission's penalties statement, and the $50 million penalty imposed by OFHEO, the Commission decided that a $350 million penalty in its action was appropriate even though this amount is likely far less than full restitution, which is measured by the actual losses incurred by investors as a result of Fannie Mae's fraud. Restitution historically has been awarded in criminal securities cases, not in civil or administrative ones. As the Committee knows, the Commission's jurisdiction is civil and administrative; consequently, restitution is not a measure of relief that the Commission has won in cases like this one. Nonetheless, the Commission, in doing what it can to provide financial relief to investors, always strives to secure maximum disgorgement and legally appropriate penalties in its cases, including the case against Fannie Mae.

Addendum

Securities and Exchange Commission Rule Changes

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55198; File No. SR-NYSE-2006-116)

January 30, 2007

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change Amending Annual Report Timely Filing Requirements

I. Introduction

On December 14, 2006, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend Section 802.01E of its Listed Company Manual ("Manual") to end, as of December 31, 2007, the Exchange's discretion to continue the listing of certain companies that are twelve months late in filing their annual reports with the Commission. The proposed rule change was published for public comment in the Federal Register on December 28, 2006.[3] The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange proposes to amend Section 802.01E of the Manual to end, as of December 31, 2007, the Exchange's discretion to continue the listing of certain companies that are twelve or more months late in filing their annual reports[4] with the Commission.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 54977 (December 20, 2006), 71 FR 78249.

4 The term "annual report" used herein refers to the filing of Forms 10-K, 10-KSB, 20-F, 40-F or N-CSR.

Section 802.01E of the Manual provides that if a company fails to timely file a periodic annual report with the Commission, the Exchange will monitor the company and the status of the filing. If the company fails to file the annual report within six months from the filing due date, the Exchange may, in its sole discretion, allow the company's securities to be traded for up to an additional six-month period depending on the company's specific circumstances; but in any event if the company does not file its periodic annual report by the end of the one year period ("Initial Twelve-Month Period"), the Exchange will begin suspension and delisting procedures in accordance with the procedures in Section 804.00 of the Manual.

Section 802.01E states that, in certain unique circumstances, a listed company that is delayed in filing its annual report beyond the Initial Twelve-Month Period may have a position in the market (relating to both the nature of its business and its very large publicly-held market capitalization) such that its delisting from the Exchange would be significantly contrary to the national interest and the interests of public investors. In such a case, where the Exchange believes that the company remains suitable for listing given, among other factors,[5] its relative financial health and compliance with the NYSE's quantitative and qualitative listing standards, and where there is a reasonable expectation that the company will be able to resume timely filings in the future, the Exchange may forebear, at its sole discretion, from commencing suspension and delisting, notwithstanding the company's failure to file within the time periods specified in Section 802.01E of the Manual.

The Exchange has determined that it is unnecessary for the Exchange to retain the discretion to allow companies to continue to be listed beyond the Initial Twelve-Month Period

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[5] See Section 802.01E of the Manual for a complete list of the factors that the Exchange must consider when determining whether to continue listing a company beyond the Initial Twelve-Month Period.

after December 31, 2007. Therefore, under this proposed amendment, the Exchange's discretion to allow a company to continue to be listed beyond the Initial Twelve-Month Period set forth in Section 802.01E of the Manual shall expire on December 31, 2007. If, prior to December 31, 2007, the Exchange had determined to continue listing a company beyond the Initial Twelve-Month Period under the circumstances specified in Section 802.01E of the Manual as described above,[6] and the company fails to file its periodic annual report by December 31, 2007, suspension and delisting procedures will commence in accordance with the procedures set out in Section 804.00 of the Manual.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act[7] which requires an Exchange to have rules that are designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.[8]

Specifically, the Commission believes that eliminating the Exchange's discretion to continue the listing of certain companies that are twelve months late in filing their annual reports will encourage listed companies to file any late annual reports as quickly as practicable. This should benefit the public interest and protect investors by helping to assure that investors receive

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6 See supra note 5 and accompanying text.

7 15 U.S.C. 78f(b)(5).

8 In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

up to date financial information about listed companies. Eliminating the Exchange's discretion to not commence delisting of a company past the Initial 12 Month Period ensures that companies cannot continue to trade on the Exchange for extended periods of time without making publicly available their required annual reports.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[9] that the proposed rule change (SR-NYSE-2006-116) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Florence E. Harmon
Deputy Secretary

9 15 U.S.C. 78s(b)(2).

10 17 CFR 200.30-3(a)(12).

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM STEPHEN B. ASHLEY

Q.1. The OFHEO report states that Fannie lobbyists "used their longstanding relationships . . . to interfere with OFHEO's special examination" of Fannie Mae. The Rudman report states that Fannie had "a reputation for lecturing lawmakers" and "a sophisticated lobbying organization that was known to be aggressive." In July 2004, Fannie ran television advertisements that were critical of GSE regulatory reform efforts the week before a Senate Banking Committee mark-up. Both of you were at Fannie when this occurred. Were the costs of these television advertisements reported in your lobbying disclosure expenses? How does lobbying further your statutory housing mission? Is it appropriate for a congressionally chartered institution to use funds earned under the benefit of its GSE status to lobby against congressional efforts to strengthen that institution's oversight? Has FASB looked at any additional studies to see whether this might be a possibility?

A.1. The 2004 advertising referred to was included in the total reportable lobbying expenses under Fannie Mae's 2004 Lobbying Disclosure Act (LDA) report. The company has not undertaken any advocacy advertising since 2004.

Fannie Mae's management and board have made repairing our working relationships with our regulators and Congress, and establishing a new tone and manner in the way we communicate with policymakers, customers, and partners top corporate priorities. The company has reduced its lobbying operation significantly since

2004, and we remain committed to reversing the sometimes heavy-handed nature in which the company engaged with policymakers in the past.

We believe it is very important that the company maintain an appropriate, professional, and responsive relationship with the regulators who oversee our business and with Congress, which chartered us to fulfill our housing mission.

Fannie Mae communicates with government officials at all levels to provide information about the company and its role in the secondary mortgage market. Communication between government officials and Fannie Mae facilitates the exchange of important information and ideas on a variety of topics including mortgages, affordable housing, and capital markets. The company's government relations activities comply with applicable disclosure regulations.

Fannie Mae continues to support passage of legislation to create a strong, well-funded regulator that would oversee the safety and soundness and the housing mission of the enterprises, and the company's government relations staff provides information to policymakers as appropriate with regards to this effort.

We are unaware of any studies by the Financial Accounting Standards Board (FASB) about this matter.

Q.2. How many outside lobbyists and consultants does Fannie Mae have a contract with? What is the total number from 1998–2006? What was the total amount of money paid to these individuals for consulting and/or lobbying services for each of these years? How much of that money was ultimately reported under the lobbying disclosure act?

A.2. Currently, Fannie Mae has 19 external lobbying firms that are expected to file Federal LDA reports identifying Fannie Mae as a client for the semiannual period January to June 2006.

From 1998 to 2005, the total number of firms that reported lobbying activities identifying Fannie Mae as a client and were registered lobbyists under the LDA ranged from 11 to 24 firms per year. The number of lobbying firms by year is provided below:

1998	1999	2000	2001	2002	2003	2004	2005
11	16	14	19	24	22	23	23

The total amount of retainers and expenses paid by Fannie Mae to these firms by year is identified below. A number of the firms were law firms that, in addition to providing lobbying services, also provided legal services to Fannie Mae on matters unrelated to lobbying (such as litigation, real estate, and securities disclosure). The costs for all of these services is included.

1998	1999	2000	2001	2002	2003	2004	2005
$2.09M	$3.45M	$3.41M	$5.56M	$7.94M	$11.67M	$7.36M	$4.67M

The total amount of lobbying income related to lobbying activities on behalf of Fannie Mae reported by these lobbying firms on LDA reports is as follows:

1998	1999	2000	2001	2002	2003	2004	2005
$1.00M	$1.69M	$2.03M	$2.49M	$2.79M	$2.32M	$2.95M	$2.16M

As allowed by the LDA, Fannie Mae has always used the tax method to report its lobbying expenses; the company is required to make a good faith estimate of lobbying expenses that are non-deductible.

To derive this estimate, Fannie Mae uses the "ratio method" whereby a corporation multiplies its total costs of operations by a fraction. The numerator of the fraction is the number of hours employees spent on lobbying activities, and the denominator is the total work hours of all the company's employees on all company activities.

The corporation adds the result of this calculation to its third party lobbying costs (such as amounts paid to outside lobbying firms, dues, legal fees associated with lobbying, *etc.*) to determine its total lobbying expenses.

As noted, this method of calculating a company's lobbying expenditures is heavily impacted by the corporation's overall costs. Accordingly, despite a reduction in the amount paid to outside lobbying firms, Fannie Mae's overall lobbying costs as reported in its 2005 LDA filing grew, mostly due to the significant increase in the company's overall operating costs that year, which in 2005 were related to the company's restatement.

Accordingly, Fannie Mae reported the following total lobbying expenditures through the company's LDA filings:

1998	1999	2000	2001	2002	2003	2004	2005
$5.55M	$7.01M	$7.0M	$6.57M	$7.59M	$8.7M	$8.79M	$10.08M

Q.3. The OFHEO report states that the "Board contributed to those problems by failing to be sufficiently informed and to act independently of its chairman, Franklin Raines, and other senior executives; by failing to exercise the requisite oversight over the Enterprise's operations; and by failing to discover or ensure the correction of a wide variety of unsafe and unsound practices."

It further reads "the members of the Board were all knowledgeable and qualified individuals, fully capable of understanding the business and corporate governance duties with which they were charged."

"The Board's failures continued in the wake of revelations of accounting problems and improper earnings management at Freddie Mac and other high profile firms, the initiation of OFHEO's special examination, and credible allegations of improper earnings management made by an employee of the Enterprise's Office of the Controller."

A.3. As I testified, the Fannie Mae of 1998–2004 portrayed in the final OFHEO report of its special examination is a far different company than was portrayed to the Fannie Mae Board by departed management, our former external auditor, and annual regular examination reports.

I agree that Fannie Mae's board was composed of capable and qualified directors who in my perception were concerned with the strength of the Enterprise and its important mission. During the years examined in the OFHEO report, I believed the board came prepared for our meetings, asked the right questions, and appeared to be actively engaged in their duties of oversight. It was not my impression at the time that my colleagues on the board lacked independence from Mr. Raines or other senior executives. As a result of the investigations by both Senator Rudman and OFHEO, however, I have learned of a number of matters that I did not know at the time and that, in hindsight, I would have wanted to know as a member of the board.

Following the issuance of OFHEO's report on its special examination of Freddie Mac, the board asked Fannie Mae's senior management and its outside auditors whether the issues identified in that report were also issues at Fannie Mae. The board as a whole received reports from different members of senior management on several separate occasions in response to these questions. In addition, the Audit Committee of the board received its own detailed presentation on these issues from senior management and the outside auditors. Throughout these presentations, we were assured that the problems identified at Freddie Mac were not present at Fannie Mae.

In addition, it is my understanding that management informed the Audit Committee about accounting allegations made by Roger Barnes and that the allegations had been investigated. I also understand that the committee was told that Mr. Barnes had agreed that appropriate action had been taken in response to his concerns.

The board has learned a lot of lessons, and we have worked to apply what we have learned. As I testified, since the initial OFHEO special examination report of September 2004, the board has continued to make significant changes to its composition, structure, and relationship to management:

- We separated the roles of the Chief Executive Officer and the Chairman of the Board, as it was essential to establish the appropriate governance and oversight of management, assuring all parties that we were progressing on our agreed-upon goals.
- Five of the 12 nonmanagement members are new since 2004, and the newest member, Dennis Beresford, is a former chairman of the FASB and serves as chair of the Audit Committee. All five of the new board members are independent of management. We eliminated two of the seats held by management, retaining just one, to increase the proportion of independent board members. In accordance with our corporate policy and OFHEO's corporate governance rules on length of service, another board member, Ann Korologos, will be leaving the board effective July 31, 2006.
- To ensure accountability and the timely flow of information, we established reporting lines to the board for the positions of

Chief Audit Executive, Chief Compliance and Ethics Officer, and Chief Risk Officer.

- To improve our relationship with our regulators and to hear about any problems directly, I and other members of the board have established regular interactions with OFHEO.

Q.4. The OFHEO report states that Fannie Mae lobbyists "worked to insure that the agency (OFHEO) was poorly funded" and "used longstanding relationships with Congressional staff . . . to interfere with OFHEO's special examination" of Fannie Mae.

What is your knowledge of this? Were you aware of this lobbying effort? If you were aware of it why didn't you stop it?

The OFHEO report states the Board was notified of the HUD Inspector General's results. Mr. Ashley, the report also states (on page 276) you were notified about the results in 2004. Why were you notified about the results. Do you encourage this type of behavior at Fannie? If not, what did you do to specifically discourage it?

A.4. Throughout the course of the special examination the board directed the company to cooperate fully with OFHEO. We received periodic reports about the company's responses and were repeatedly assured that the company was cooperating and would continue to cooperate fully. Throughout this period, I never saw or heard anything that suggested that the company was attempting to obstruct OFHEO's special examination through lobbying efforts or otherwise.

As for the HUD Inspector General's (IG) review of OFHEO, I recall learning the results of the review at the time they were reported in the press in November 2004. As noted in the OFHEO report (p. 276, fn. 165) I was also sent an e-mail from a Fannie Mae officer summarizing the press reporting on the topic. Keeping myself informed of the results of such a review of the company's regulator was fully consistent with my obligations as a board member.

At no time was I ever informed that the IG's review of OFHEO was part of any effort by Fannie Mae to obstruct OFHEO's special examination of Fannie Mae. As I previously testified, management and the board have made establishing a new tone, manner, and approach in the way we interact with regulators and policymakers a top corporate priority.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM STEPHEN B. ASHLEY

Q.1. Acting Director Lockhart has noted that Dan Mudd's memo where Mr. Mudd stated:

> The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition . . . We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us. We now operate in a world where we will have to be 'normal' is the best written record of the arrogant and unethical corporate culture at Fannie Mae from 1998 to 2004.

Given such an assessment, why do you feel that Dan Mudd is the best man to lead Fannie Mae into the future?

A.1. I will elaborate further about our comprehensive review of Dan in the context of our agreement with OFHEO in response to a subsequent question.

As I testified, the board selected Dan Mudd as President and CEO of Fannie Mae in June 2005 after an extensive, competitive nationwide search and careful and deliberate consideration, including consultation with OFHEO and a targeted review by Senator Rudman. As interim CEO, Dan demonstrated an ability to lead a large financial institution through a major and challenging transition, including the ability to reach out and rebuild confidence with our regulators, Congress, and others. He demonstrated his capacity for the job by doing the job and he retains the confidence of the board. Since taking the helm, I believe Dan has effected positive changes in the culture of Fannie Mae. He has met our expectations. We chose him for his excellence in critical areas, and he has justified our choice.

With regard to Dan's memorandum, I accept what he has explained in answering these questions from the Committee:

> As discussed during my June 15, 2006, testimony, the thrust of my November 16, 2004, memorandum was in no way an endorsement of the preexisting tone and attitude at Fannie Mae. The purpose of the memorandum was to reject the preexisting tone and attitude and encourage the company to change. A central theme of the memorandum was the importance of improving our relationships with OFHEO and our other regulators, including the SEC. My memorandum was attempting to provide a 'wake up call' that change was necessary to meet the challenges of the more competitive and evolving financial markets.
>
> For much of its life span, Fannie Mae had a practically unique position in American financial markets. This 'peculiarity' meant that rules had to be created to address aspects of Fannie Mae's business that were different from other financial institutions. Thus, as my memorandum noted, we 'faced little organized political opposition' during that era. However, as the financial markets have become more sophisticated and competitive, Fannie Mae became less unique and there was less need for Fannie Mae-specific rules. My memorandum does not indicate that the 'old political reality' from the bygone era was appropriate. Nor did I suggest or condone any effort to eliminate political opposition. There are and will be strongly opposing views about the financial markets and Fannie Mae's role in that arena. Fannie Mae recognizes that robust debate in this area is appropriate and healthy.
>
> I strongly believe that a properly functioning, professional relationship with our regulators is in the best interest of our company and the housing markets, and I have made it a top priority since becoming CEO to repair and strengthen those relationships. I have also made it clear from day one that the approach, tone and manner with which we engage policymakers has needed to change, and I hope we have made significant strides in this regard.

Q.2. Responsibility for overseeing operational risk was primarily given to Frank Raines, but was then handed to Dan Mudd, Fannie's current CEO. What was Mudd's role as COO and to what degree was he responsible for what happened at Fannie Mae? How should he be held accountable?

A.2. When he was Chief Operating Officer, Dan Mudd's responsibilities primarily were dealing with Fannie Mae's customers and with the systems technology, and employees in those areas reported to him. While reporting structures changed from time to time at Fannie Mae during my tenure on the board, by 2003 all credit and risk personnel, including the Senior Vice President for Operations and Risk, reported to the Chief Financial Officer. Dan also did not oversee financial accounting, the mortgage portfolio, or internal audit.

As I testified, the board selected Dan Mudd as President and CEO of Fannie Mae in June 2005 after an extensive, competitive nationwide search and careful and deliberate consideration, including consultation with OFHEO and a targeted review by Senator Rudman. Indeed, when it was clear that Dan was going to be a finalist for the position, I approached Senator Rudman, and had discussions with the then-director of OFHEO, as to whether there was anything in their knowledge that would suggest that the board should not move forward in considering Dan as a finalist. Senator Rudman's team spent about 2 to 3 weeks doing very in-depth reviews of Dan's work at the company, examining whether he was in any way implicated in any of the wrongdoing that had been identified in the September 2004 OFHEO report. Senator Rudman's investigation was thorough. He met with the board's search committee and then later with the full board to discuss the results of his investigation. At that point, the board felt there was no reason why Dan should not be considered for the CEO position, and we subsequently appointed him CEO.

Then, a week before OFHEO released its final special examination report in May of this year, a draft was made available to a small group under confidentiality for fact checking. At that time, we learned Dan was named several times in the report. Therefore, I felt that the board had to examine those findings and discuss them thoroughly, and did so. We asked Senator Rudman to read the report, to come back to us and address questions as to whether there were any new or different material findings that would cause the Senator and his team to change their opinion and their previous recommendation to the board regarding Dan's service as CEO. Senator Rudman reported that there was not any reason to change his opinion.

The board continues to have full confidence in Dan Mudd as CEO of Fannie Mae.

Under Fannie Mae's May 23, 2006, settlement agreement with OFHEO, the board of directors appointed a special committee of four independent board members (three of whom have joined the company subsequent to the end of 2004) which is conducting the personnel review prescribed by the agreement, including "plans to seek restitution, disgorgement, or other remedies to recover funds from individuals." Mr. Mudd has stated publicly that he will abide by the decisions of the committee with regard to this matter.

Q.3. Fannie Mae senior executives omitted critical information to the Board leaving directors with a false sense of reassurance. Management is at fault, but what role should the board have played and why did they just accept and not question what management presented? The OFHEO report holds the Board more responsible than the Rudman report did, why is that?

A.3. The board of directors of every public company is responsible to act diligently, independently and on an informed basis in its oversight of the management of the corporation. In my view, Fannie Mae's board of directors discharged these responsibilities even though, in hindsight, information has come to light that was not made known to the board of directors at the time. As I discussed in responding to a question from Senator Hagel, in my opinion, the members of Fannie Mae's Board of Directors were well-qualified for their position, thoughtful, informed and engaged in the interactions that I observed with the management of the company.

As I testified, the Fannie Mae of 1998–2004 portrayed in the final OFHEO report of its special examination is a far different company than was portrayed to the Fannie Mae board by departed management, our former external auditor, and annual regular examination reports. During the years examined in the OFHEO report, I believed the board came prepared for our meetings, asked the right questions, and appeared to be actively engaged in their duties of oversight. It was not my impression at the time that my colleagues on the board lacked independence from Mr. Raines or other senior executives. As a result of the investigations by both Senator Rudman and OFHEO, however, I have learned of a number of matters that I did not know at the time and that, in hindsight, I would have wanted to know as a member of the board.

We learned a lot of lessons, and have worked hard to apply what we have learned. As I testified, since the initial OFHEO special examination report of September 2004, the board has continued to make significant changes to its composition, structure, and relationship to management:

- We separated the roles of the Chief Executive Officer and the Chairman of the Board, as it was essential to establish the appropriate governance and oversight of management, assuring all parties that we were progressing on our agreed-upon goals.
- Five of the 12 nonmanagement members are new since 2004, and the newest member, Dennis Beresford, is a former chairman of the FASB and serves as chair of the Audit Committee. All five of the new board members are independent of management. We eliminated two of the seats held by management, retaining just one, to increase the proportion of independent board members. In accordance with our corporate policy and OFHEO's corporate governance rules on length of service, another board member, Ann Korologos, will be leaving the board effective July 31, 2006.
- To ensure accountability and the timely flow of information, we established reporting lines to the board for the positions of Chief Audit Executive, Chief Compliance and Ethics Officer, and Chief Risk Officer.

- To improve our relationship with our regulators and to hear about any problems directly, I and other members of the board have established regular interactions with OFHEO.

As for the question why the OFHEO report holds the board more responsible than did Senator Rudman's report, I respectfully wish to defer to the authors of those reports. But I emphasize that the board takes the findings of both of those reports seriously, and we are committed to addressing the issues therein.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM DANIEL H. MUDD

Q.1. Mr. Mudd, in your testimony, you noted that "Fannie Mae will work cooperatively to support the efforts of Congress to pass legislation to strengthen GSE regulation." Senators Sununu, Dole, and I have been circulating a letter to Chairman Shelby and Majority Leader Frist expressing the need to pass effective GSE reform this year and urging Senate leadership to bring 8.190 to the floor where the full Senate can debate the merits of the bill. To date, we have 26 Senators on the letter and the list is growing. Do you support the merits of this letter?

A.1. As I testified in my opening statement before the Committee in June, our position remains the same as when I testified in April 2005. While it would be inappropriate for Fannie Mae to comment on how or when the Senate should take up this debate, I can assure you that we will continue to work cooperatively to support the efforts of Congress to pass legislation to strengthen GSE regulation. In particular, we continue to support legislation:

- To create a single independent, well-funded regulator with oversight for safety and soundness and mission;
- To provide the regulator with strong bank-like regulatory powers over capital, activities, supervision, and prompt corrective action;
- To provide the regulator with bank-like authority to reduce on-balance sheet activities, based on safety and soundness; and
- To provide a structure for housing goals that includes an affordable housing fund that strengthens our housing and liquidity mission.

Q.2. According to the OFHEO report, you wrote in an e-mail in 2003:

> I spoke to [a Treasury Department official], he had agreed to talk to [the SEC] on 'what to do if OFHEO was not falling in line' already ([another Treasury official] had already bent his ear about OFHEO obstructionism) . . . promised me he'd check in to see where things were and would call [the SEC] when needed.

Can you respond to this? How does this fit in with your calls to change the tone of Fannie Mae?

A.2. The e-mail related to a call I made to a Treasury official during the time Fannie Mae was seeking and preparing for our voluntary registration with the SEC, an effort I supported to improve Fannie Mae's transparency and bring the company into line with

other large public financial institutions. As the date approached for the filing of our first Form 10-K with the SEC, we learned that OFHEO disagreed with Treasury and the SEC about some aspects of the registration process. I called the Treasury official for guidance and clarification of the positions of the three agencies, solely with respect to interagency disagreements regarding the registration process.

I want to emphasize that I did not make the call to generate conflict or to interfere, in any way, with OFHEO regulation of Fannie Mae. I meant the call as a good-faith attempt to obtain guidance about our regulatory obligations as we expanded Fannie Mae's financial reporting through SEC registration.

As for Fannie Mae's tone and manner, I could not agree with you more—as I testified, the days of the arrogant, defiant, "my way" Fannie Mae had to end. As CEO, I have explicitly made building stronger, cooperative relationships with our regulators and Congress, and changing our culture to one of service and humility, among our top corporate priorities. We have made many changes, and we are committed to making more.

Q.3. The OFHEO report states that "by deliberately and intentionally manipulating accounting to hit earnings targets, (Fannie's) senior management maximized the bonuses and other executive compensation they received, at the expense of shareholders." You received a total of $26.3 million in executive compensation from Fannie between 2000–2004. Do you plan to return any of it? What is your total compensation for 2005 and 2006?

A.3. Under Fannie Mae's settlement agreement with OFHEO, the board of directors has appointed a special committee of four independent board members (three of whom joined the company subsequent to the end of 2004), which is conducting the personnel review prescribed by the agreement, including "plans to seek restitution, disgorgement, or other remedies to recover funds from individuals." I have stated publicly that I will abide by the decisions of the committee with regard to this matter.

Prior to being named the company's President and CEO on June 1, 2005, I earned a base salary of $850,000. Upon being named President and CEO, my base salary rose to $950,000 for the remainder of the year. I also received a cash bonus of $2,591,875 for the 2005 performance year, and was granted restricted shares of company stock valued at $8,000,000, subject to a vesting period of 4 years.

My annual salary for 2006 remains at $950,000. My 2006 annual cash bonus award target is 275 percent of my annual base salary. Decisions on additional compensation provisions for 2006 are at the discretion of the company's board of directors and have not been determined.

Q.4. The OFHEO [report] states that

> In 2003, three Fannie Mae employees expressed serious concerns about the Enterprise's accounting. Roger Barnes, then a manager in the Office of the Controller, made allegations about Fannie Mae's accounting for deferred price adjustments under FAS 91 to Sampath Rajappa, Senior Vice President for Operations Risk, who then reported

> those concerns promptly to Ann Kappler, Senior Vice President and General Counsel.
>
> Another employee in Securities Accounting also expressed concerns about amortization accounting to Chief Operating Officer Daniel Mudd, and a third employee echoed those concerns. Ms. Kappler and Mr. Mudd initiated flawed investigations into those allegations and concerns. When those investigations were completed, Ms. Kappler made statements about the issues raised and their disposition—in one case, to the Audit Committee of the Board of Directors—that were false and misleading.

Can you respond to this? When did you become aware of Fannie's accounting problems? What were your responsibilities as Chief Operating Officer? Which employees reported to you? Did the Senior Vice President for Operations and Risk report to you?

A.4. While I carried the title of Chief Operating Officer (COO), my responsibilities, as assigned by the Chainnan and CEO at the time, primarily were working with Fannie Mae's customers and dealing with the systems, technology, and employees in those areas that reported to me. While reporting structures changed from time to time at Fannie Mae during my tenure as COO, by 2003 all credit and risk personnel, including the Senior Vice President for Operations Risk, who ran internal audit, reported directly or indirectly to the Chief Financial Officer. I also did not oversee financial accounting or the mortgage portfolio.

I first learned that OFHEO had concluded that certain aspects of Fannie Mae's accounting were wrong upon release of the September 2004 OFHEO report. Like a lot of people, I was stunned.

As CEO, my number-one priority has been to get our accounting right and fix our systems, internal controls, organization, and other issues as we complete our restatement by the end of this year.

The Securities Accounting employee cited in the OFHEO report, Michelle Skinner, raised a question about accounting during an open-forum, town hall-style meeting I held with employees on a regular basis, which the company called an "unplugged" meeting. For unplugged meetings, employees were invited to ask questions on any type of issue or concern—ranging from complicated business and work issues, to the food served in the cafeteria, and the coverage limits of the dental plan. In the September 9, 2003, session, Ms. Skinner asked a complex accounting question. Because I am not a trained accountant and do not have expertise in the field, and because the financial accounting function did not report to me during my service as COO, I could not answer her question on the spot. So I invited Ms. Skinner to send an e-mail to me explaining her concerns in greater detail.

When I received her e-mail, I asked my assistant—a former securities lawyer—to ensure answers were provided in response to Ms. Skinner's questions. The matter was referred to Internal Audit, the General Counsel, and the Controller's Office. By late September, Internal Audit provided to me its assurance that issues raised by Ms. Skinner were being handled by the company in a manner consistent with GAAP. I was also told that our external auditor, KPMG, reviewed these issues and found the treatment acceptable.

At my direction, a November 17, 2003, tutorial session was organized to address the questions that had been raised by Ms. Skinner in greater depth and in an open dialog with interested employees. It is my understanding that Ms. Skinner and Mr. Anthony Lloyd (the "third employee" referenced in the question) stated that they were satisfied with the response and that their concerns had been addressed. At the time, I believed that the issues were being thoroughly reviewed and that a full and accurate response was provided by offices and individuals experienced and knowledgeable in the area. At all times, I tried to address Ms. Skinner's inquiry openly and thoroughly.

Q.5. The OFHEO report states Fannie's "corporate culture was intensively focused on attaining Earning Per Share (EPS) goals" and "senior management provided an incentive to employees to double EPS to $6.46 by year-end 2003."

In the same year, Sampath Rajappa, Fannie's Senior Vice President for Operations Risk and head of Internal Audit told Fannie's internal audit group: "you must be obsessed on $6.46. After all, thanks to Frank [Raines], we all have a lot of money riding on it . . . Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP [Employee Stock Purchase Program] but substantially over that if we make $6.46." The final EPS number for 2003 was $7.29 which triggered the bonuses.

Is this the right message to be sending to your company's internal audit group?

According to the OFHEO report, meeting this goal—and triggering the option grants and bonuses—was a primary goal of senior management. In a 2000 memo, you wrote:

> We also need to continue to focus on our 2003 challenge . . . we still have a gap of nearly $375 million in pre-tax income . . . ! know that the numbers in our Q3 forecast around our 'big bets' are still being refined as we iron out the issues—and that those revenue numbers may well change. It is clear that these new products may not be sufficient to get us to our $6.46 goal—and we as a company must be looking hard at what it will take to make it.

When did you become aware of this EPS incentive plan? Were you aware that this incentive plan was extended to internal audit employees? Who reviewed these targets? Did you have the ability to review these targets? Can you also provide the Banking Committee a copy of this memo?

A.5. As I testified, I was not aware of Mr. Rajappa's speech at the time, and it is deeply troubling to me. I don't think that's the way that an audit staff should be focused, and I and the board have made a priority of changing that since I took the job of CEO. As I also testified, I believe it's very important that the audit staff be independent and report directly to the board, and that its compensation be independent of the company's financial results.

With these principles in mind the board and management have completely overhauled the internal audit function to ensure it is the corporate guardian it is supposed to be. The Chief Audit Executive is a new external hire who reports directly to the Audit Committee of the board of directors with a dotted line reporting to the

CEO. This position has increased direct interactions with, and enhanced detailed reporting to, the board's Audit Committee and its chair (who is a new Fannie Mae board member, Dennis Beresford, a former chair of the Financial Accounting Standards Board). The Internal Audit function also has undergone a comprehensive organizational and process redesign, including new structure, staffing levels, skill assessments, audit planning processes, execution, and reporting. The company has also replaced its outside auditor with Deloitte and Touche, LLP, which formerly provided advice to OFHEO when several of the accounting problems were first identified and is now conducting a comprehensive re-audit of the entire company with more than 300 auditors onsite at Fannie Mae.

As Fannie Mae Chairman, Steve Ashley, said during his testimony:

> During the 1990s and the early part of the decade of 2000 this was an accepted and indeed promulgated form of compensation in addition to base compensation that most of corporate America publicly owned corporate America—engaged in one Finn or another. The purpose was to align the management of the company with the interests of the shareholders.

I was aware of the EPS goal when I arrived at Fannie Mae in 2000 because the company announced it broadly—publicly and internally—when it was launched in 1999, and it remained a corporate financial stretch goal through 2003. The incentive was available to all full-time employees of the company. And as I noted in my appearance before the committee, this was a compensation structure similar to other companies that I had worked for previously and which I thought appropriate in those circumstances.

The company has now adopted a new executive compensation structure with broad performance goals that include achieving affordable housing mission goals, improving our culture, complying with regulatory standards, and delivering shareholder value. In addition, Fannie Mae's Consent Order with OFHEO explicitly requires the board to ensure that our compensation practices "include financial and nonfinancial metrics and shall not be tied exclusively to earning per share" and that "compensation metrics for the internal auditor, chief compliance officer, controller, and such others, as determined in consultation with OFHEO, be appropriate to their roles and do not create a conflict of interest."

Regarding my memorandum of October 12, 2000, as I testified, all companies that I'm familiar with have budgets with targets for revenues and expenses, and compensation plans that have targets in them. Part of my responsibilities as COO was to review the profits and losses of that part of the business I was running and to try to attain the goals set by the organization. Never at any point would I sanction any departure from the rules in order to hit EPS targets.

In response to your request, my memorandum is being provided to the Committee as an attachment to these responses.

Addendum

Memorandum from Dan Mudd

FannieMae

Date : October 12, 2000

To : Tom Donilon
Tim Howard
Lou Hoyes
Rob Levin
Adolfo Marzol
Julie St. John
Michael Williams

From : Dan Mudd

Subject : QBR – November 1-2

Attached is a preliminary agenda for the upcoming Quarterly Business Review sessions. Leanne will present the overview of our financial outlook on October 18 from 3-4pm so that business and division heads will know where the corporate numbers stand in advance of the individual QBR sessions on November 1 and 2.

The primary focus for the QBR sessions needs to be on meeting our goals for 2001 through 2003. I don't want to spend time in these sessions talking about "where we are" – I want all the time to be spent focusing on how we are going to get to where we want to be.

Our immediate challenge is 2001 – our latest forecast indicates that we are short of our goal by about $150 million in pre-tax net income. Each business head should be ready to discuss his P&L for next year, with a focus on revenue, preliminary expense, and net income growth rates over 2000, as well specific actions to help fill our projected shortfall.

We also need to continue to focus on our 2003 challenge. Our outlook for that year has improved from the last forecast, but we still have a gap of nearly $375 million in pre-tax net income. Also, a substantial portion of our improvement was the result of lower forecasted interest rates and an improved mortgage market outlook – and we can't count on that continuing. I know that the numbers in our Q3 forecast around our "big bets" are still being refined as we iron out the issues – and that those revenue numbers may well change. It is clear that these new products may not be sufficient to get us to our $6.46 goal – and we as a company must be looking hard at what it will take to make it.

In terms of our outlook through 2003, I think we need to focus on the following:

- Each business should be prepared to discuss their long-term outlook (1998 through 2003) in terms of revenue growth, expense growth and net income growth.
- I would also ask each business head to review any seriously off-track corporate objectives and to outline what steps are being taken to get back on track. If you do not expect to be on track by year-end, please bring with you the written explanation you plan to provide to the Board of Directors.
- The portfolio business, which is the most sensitive part of our business to interest rates, should quantify the risk to our current outlook to a change in rates.
- At the EVP meeting with Frank in September, Tim agreed to work on developing a framework for reviewing the risk/return tradeoffs in our projected funding and I would like a report on that work.
- I would ask Lou and his team to give us an updated report on new product/"big bets" —including revised income numbers and a list of outstanding/unresolved issues.
- Ken should be prepared to follow-up on his promise to work on business ideas to add revenue for the Multifamily business.
- I'd ask Rob and his team to provide a complete status report on all of our housing goals, and Rob and Lou should provide an update on our plan to improve our minority numbers.
- Rather than have a separate credit policy session this quarter, I would ask that Adolfo and the credit heads coordinate any issues that need to be discussed as part of the appropriate business session. And, as before, all EVPs are welcome as active participants in all sessions.
- Please take time to review my memo of August 18 to make sure all of the follow-ups from the August QBR have been addressed.
- Finally, we all should come prepared to discuss new, out of the box ideas to meet our $6.46 goal.

Cc: Jamie Gorelick
Ken Bacon
Lynda Horvath
Linda Knight
Tom Lawler
Tom Lund
Peter Niculescu
Mike Quinn
Jayne Shontell
Leanne Spencer
Phil Weber
Barry Zigas

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DANIEL H. MUDD

Q.1. Fannie Mae signed a consent agreement on May 23, 2006, with the Office of Federal Housing Enterprise Oversight agreeing to cap its retained mortgage related portfolio to $727 billion, its level on December 31, 2005. Using Fannie Mae's $727 billion portfolio as a model, what would Fannie Mae's portfolio size be with the limits of S. 190? Please include an explanation of the assumptions that you used to arrive at this number?

A.1. Under S. 190, the size of Fannie Mae's portfolio would be the sum of the seven permissible assets listed in the bill. While several

of these asset definitions could be subject to some interpretation (*e.g.,* "mortgages and mortgage-backed securities for the purpose of securitization" and a "limited inventory of mortgages solely for the purpose of supporting the guarantee business"), in our analysis a literal reading of the bill would lead to a reduction in the size of our portfolio to a range of $10 billion to $100 billion.

We summarize below our best estimates of the projected size of Fannie Mae's portfolio under the provisions of S. 190, broken down into the seven permissible asset categories listed in the bill. We note, where appropriate, any assumptions we make concerning the bill's provisions and/or future conditions and behavior in the housing, secondary mortgage, and capital markets.

Summary of Estimates of Fannie Mae's Assets under S. 190

S. 190, Sec. 109 Category	Asset Category	Amount
1	Whole Loans and MBS for the purpose of Securitization	$2-20B.
2	Non-Securitizable mortgages acquired to meet affordable housing goals	$2-20B.
3	Mortgages solely for the purpose of supporting the guarantee business	$2-50B.
4	Real estate acquired through foreclosure	$2-5B.
5 & 7	Cash and U.S. Treasury Securities (held for liquidity purposes)	$1-3B.
6	Other Assets	$1-2B.
Total		$10-100B.

1. *Mortgages and mortgage-backed securities for the purpose of securitization: $2–20 billion*. We assume this category would consist of whole loans purchased from lenders that are in the process of conversion into mortgage-backed securities (MBS) and eventual sale. These loans may need to be held on the balance sheet to optimize security sales. Loans or packages of loans from disparate lenders, delivery mechanisms, or delivery months may need to be aggregated over some period of time to achieve the best available price in the securities market.
2. *Mortgages acquired to meet affordable housing goals, if such assets are not readily securitizable: $2–20 billion.* Currently, Fannie Mae holds approximately $250 billion of mortgage loans on our balance sheet. A literal reading of the phrase "if such assets are not readily securitizable" would preclude us from holding almost all of these loans, whether or not they qualify as affordable housing loans, since almost all loans are readily securitizable at some price. Of the loans on our balance sheet, more than 90 percent could be securitized by lenders through programs currently offered by Fannie Mae. In general, loans acquired and held on our balance sheet tend to meet our affordable housing goals criteria at a greater rate than loans placed in MBS. For example, of loans acquired on our balance sheet in 2005, 61 percent met our low and moderate-income affordable goal (compared to 46 percent of loans in MBS), 35 percent met our special-affordable goal (compared to 18 percent of loans in MBS), and 40 percent met our underserved goal (compared to 37 percent of loans in MBS).
3. *A limited inventory of mortgages solely for the purpose of supporting the guarantee business: $2–50 billion.* We interpret this category to include only those mortgage holdings that directly and solely support the guarantee business. We include loans and securities that we may need to purchase from lend-

ers as a means of retaining or improving the guarantee business with those lenders. We specifically did not include MBS holdings that provide liquidity support and thus, improve the price performance of MBS securities.

4. *Real estate acquired through foreclosure: $2–5 billion.* We base this estimate on our recent holdings of this asset class. We assume these holdings would grow somewhat as the credit guarantee business grows, but would not exceed $5 billion in scale (absent any significant rise in the rate of foreclosures).
5. and 7. *Cash and liquid investments: $1–3 billion.*
6. *Real estate, intellectual property fixtures, and equipment for use in the business operations of the enterprise: $1–2 billion.*

Based on our reading, S. 190 would bar the GSEs from investing in almost all instances in MBS. This prohibition would encompass MBS backed by loans to finance affordable housing for low- and moderate-income families, very low-income families, or underserved communities. The prohibition would also apply if the GSEs' investment in MBS promoted the liquidity of loans, especially fixed-rate loans, for middle-class homebuyers.

The Charter Act assigns important obligations to Fannie Mae, including obligations to:

- Provide stability in the secondary market for residential mortgages;
- Provide ongoing assistance to the secondary market for residential mortgages; and
- Promote access to mortgage credit throughout the Nation . . . by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

Currently, in meeting our Charter Act obligations, Fannie Mae fulfills a broader role than we could under the list of permissible investments in the bill. Consequently, the company has a much larger loan portfolio ($731 billion at the end of June 2006) than would be the case if S. 190 were enacted. Thus, we believe the bill would require the company to liquidate approximately $600 billion to $700 billion in assets.

Q.2. What are the public policy benefits and risks of the two different portfolio sizes?

A.2. As Fannie Mae testified before the Committee in April 2005, we believe that our mortgage portfolio—our original line of business since 1938—fosters liquidity and affordability in the U.S. mortgage market, especially in times of economic distress or market disruption. Unlike any other investor in U.S. mortgages, the GSEs are required by law to operate in all 50 states, under all economic conditions. This helps ensure the availability of mortgage capital through good times and bad.

We believe that mandating a large reduction in the size of our portfolio could make it difficult for the GSEs to help provide these benefits for low-, moderate-, and middle income homeowners and renters currently served by the U.S. mortgage market. We also believe the risks that have been suggested about the current GSE portfolios would be effectively addressed by granting a new GSE

regulator with bank-like powers to ensure the safety and soundness of the GSEs' operations.

As we have previously testified, we believe the GSEs' current portfolio business provides several important public policy benefits for housing.

First, the GSEs' current portfolios increase the stability of the U.S. housing sector.

Today, the U.S. housing finance system draws funds from the entire U.S. and global capital markets (including banks, Wall Street, pension funds, foreign central banks, and others) through the sale of GSE debt instruments. This vastly improves on the system it replaced, which drew funds almost entirely from U.S. bank deposits. It also is considered improbable that myriad small financial companies and mortgage bankers could access the international capital markets with the efficiency and scale that are hallmarks of the GSEs' role. Under the former system, Americans' ability to get a mortgage at reasonable rates and terms was heavily dependent on the state of the overall U.S. economy. Housing in general, including builders and the housing trades, was subject to a series of boom-bust cycles that often amplified economic cycles in the broader economy.

The capital markets funding system, backed by the GSEs' portfolios, has smoothed out chronic boom-bust housing cycles. Housing has gone from a source of general economic instability and disruption to a stabilizer, and even a driver, of economic growth. The GSEs, both in their guarantee and portfolio roles, play a central role in this capital markets model and, in fact, there has been a pronounced reduction in housing cycle volatility that correlates closely with the growth of the GSEs' portfolios over the course of the 1990s.

Susan Wachter, Professor of Real Estate and Finance at the University of Pennsylvania's Wharton School, testified last year before the Senate Banking Committee that:

> The role of mortgage market access to global capital markets as an automatic stabilizer for the U.S. economy is demonstrated by the strength of the housing sector and its role in moving the economy out of the 2001 recession. Access to international capital markets during a period of low and falling interest rates and possible deflation has resulted in additional consumer spending which has supported the U.S. economy. *This benefit that the GSEs and secondary markets provide the American consumer is a major contributory factor to the strength of America's economy today and to the long-run stability of America's economy going forward.* [Emphasis added]

Second, the GSEs' current portfolios increase the liquidity and affordability of U.S. mortgages.

The GSE portfolio purchases increase the demand for U.S. mortgages and mortgage backed securities, thus making them more tradable (*i.e.,* liquid) and putting downward pressure on the interest rates charged to homeowners. They do so in several ways.

By issuing debt to purchase mortgages, the GSEs draw in hundreds of billions of dollars from investors at home and abroad to

expand the availability and lower the cost of mortgage capital. For example, Fannie Mae's senior, long-term Benchmark Securities outstanding represented 42 percent of our total long-term debt outstanding as of the end of the second quarter of 2006, and we know that over the last eight and a half years, international investors purchased approximately one-third of those Benchmark issuances in aggregate, or $160 billion. Smaller U.S. banks (*e.g.,* community banks, agricultural banks, commercial lenders) are also substantial investors in GSE debt, demonstrating a strong preference for investing in GSE debt versus MBS issued by the GSEs. It is not at all clear that these investors would place their money in the U.S. housing market without the predictability and convenience provided by GSE debt issuances.

In addition, by investing in their own mortgage-backed securities, the GSEs create a "backstop bid" which acts as a safety net and is relied upon by other investors. A number of securities dealers have acknowledged the stabilizing force of the GSE backstop bid. Lehman Brothers, for example, has stated that "weakening of the backstop bid from the agencies . . . increases the risk in owning mortgages from a liquidity standpoint."[1]

Substantially restricting the GSEs' portfolios effectively would eliminate the backstop bid and make mortgages less liquid and less attractive investments. This could cause other investors to withdraw from the mortgage market. One respected Wall Street analyst described the process involved as follows:

> The mortgage-backed securities market is a multi-trillion dollar market. For the last 10 years they have relied quite heavily on the idea that there is a backstop bid from Fannie and Freddie when spreads widen out. Without that backstop bid, it just simply makes sense to most people on Wall Street that that's going to add volatility and some spread widening to the mortgage markets. It's very difficult to see how lenders can absorb those extra costs, and so you would have to assume some are going to get passed on to homeowners in some size or fashion.[2]

In short, the Fannie Mae and Freddie Mac portfolios, combined, finance approximately one and a half trillion dollars of U.S. conforming mortgages. Removing the GSE investment demand from the market would tend to decrease the availability of mortgage financing and increase its cost.

Third, the GSEs' current portfolio operations provide key support for the 30-year fixed rate mortgage, with a prepayment option, a home loan that distinguishes our system from most others in the world.

By creating two companies that invest only in residential mortgages, Congress laid the foundation for the 30-year fixed-rate prepayable mortgage, which is an important tool for wealth creation, stabilizing communities and neighborhoods, and allowing low- and middle-income homeowners to manage their other financial obligations without having to worry about their mortgage costs changing.

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[1] Lehman Brothers, *Mortgage Strategy Weekly,* MBS and ABS Research,4-25-2005, p. 3.
[2] Jim Vogel, FTN Financial, Memphis, Tennessee quoted on Bloomberg, August 1, 2005.

While no one can state with certainty the full impacts of portfolio restrictions on the availability of the 30-year fixed-rate mortgage, there is a real-world laboratory that shows what the market might be like without the GSEs. This is the jumbo market, which the GSEs are, by law, prohibited from participating in. There, one finds a marked difference in the incidence of fixed-rate mortgages. In 2005, the percent of mortgages used to purchase homes that were fixed rate was 74 percent in the conforming market compared to only 35 percent in the jumbo market.

The GSEs' portfolio operations in the conforming market appear to be a big factor in explaining this discrepancy. It is well recognized that ARMs tend to have higher credit risk than fixed-rate mortgages. Therefore, the absence of a GSE guarantee on a jumbo mortgage should, if anything, drive the market toward a higher supply of fixed-rate loans in the jumbo market than in the conforming market. That the opposite occurs suggests that it is the GSEs' willingness to invest in fixed-rate conforming mortgages through portfolio operations (rather than their guarantee of such mortgages) that is the driving force behind the much greater frequency of fixed-rate mortgages in the conforming market.

Fourth, the GSEs' current mortgage portfolios allow the companies to play a shock-absorbing function for the finance system during times of potential difficulty, such as the debt crisis of 1998.

The GSEs' experience in mortgage trading operations and the willingness of a broad array of investors to invest in GSE bonds gives the companies an ability to act quickly to buy mortgages in times of crisis, supporting the liquidity of the broader mortgage market.

For example, in an independent study, economists Joe Peek and James A. Wilcox asked, "How can GSEs stabilize mortgage flows?" and wrote:

> First, they may directly increase mortgage flows during recessions by purchasing whole mortgages and mortgage-backed securities to at least partially offset the procyclicality of supplies by others . . .
>
> Thus, when housing-related GSEs increase their supplies of mortgage activities in response to financial disruptions, they serve as shock absorbers that lessen the fall-off in the supplies of home mortgages . . .
>
> Having increased during (the comparison period associated with) each recession, intermediation by Fannie Mae and Freddie Mac combined was countercyclical . . . [T]he behavior of the other participants in the mortgage market was procyc1ical . . .
>
> During periods of international financial crises or of domestic economic stress . . . GSEs may be particularly well suited to facilitating mortgage flows. *So long as there are such crises and stresses, GSEs may be particularly effective in stabilizing mortgage markets and moderating business cycles.*[3] [Emphasis added]

[3] Peek, Joe, University of Kentucky and James A. Wilcox, Haas School of Business, UC Berkeley, *Secondary Mortgage Markets, GSEs, and the Changing Cyclicality of Mortgage Flows,* Ed.

Severely restricting the size of the GSEs' mortgage portfolios would reduce their capacity to serve this stabilizing role. The GSEs' charter obligations to increase liquidity and to bring stability to the market in periods of stress are complementary activities. In order to be able to fulfill the role of mortgage market stabilizers in times of market distress, a GSE must have established, during normal times, a liquid market for its securities, rather than relying upon untried securities.

In addition, the GSEs have to maintain systems infrastructure, a network of broker/dealers and a cadre of experienced staff in order to be able to conduct stabilizing operations during periods of turmoil.

In conclusion, the current GSE portfolios provide substantial liquidity and affordability benefits to the U.S. mortgage market and the homeowners and consumers that are served by that market. Restricting the GSEs to the list of investments permitted in S. 190 could make it difficult or impossible for the GSEs to help provide these benefits, especially during cycles when other investors shy away from mortgages. Finally, as we have previously stated, we believe that any risks posed by the current system would be effectively addressed through ensuring that the GSE regulator has bank-like powers to ensure the safety and soundness of the GSE operations.

Q.3. It has come to my attention that HUD Secretary Jackson plans to review the nonmortgages that Fannie currently holds, in keeping with its government charter to maintain proper safety and soundness levels. Could you please comment on what nonmortgage financial products Fannie currently holds, and also give your thoughts on the soundness of those products?

A.3. Fannie Mae's nonmortgage assets fall into three categories:

First: The company maintains a Liquid Investment Portfolio (LIP) consisting of money market and fixed-income assets with high credit quality. The purpose of the LIP is two-fold: (1) to reduce risk by providing a pool of nonmortgage investments to ensure the company could meet all of its obligations if it did not have access to the debt markets for as long as 3 months; and (2) to provide for the temporary investment of excess capital. The LIP is one major component of the company's contingent liquidity program, as detailed in a September 2005 agreement with OFHEO. We report on our nonmortgage asset holdings to HUD every quarter, and OFHEO regularly reviews our liquidity plan.

The LIP consists of money market instruments, asset-backed notes, corporate debt, and bank deposits. By corporate policy this portfolio is restricted in the type of assets it is allowed to hold as well as the overall credit quality, maturity, and duration of those assets. The average credit rating of the LIP is in the AA category. The size of the LIP varies due to changing liquidity and capital management requirements. Again, the express requirement is that Fannie Mae maintains this portfolio of nonmortgage assets in order to ensure the safety and soundness of our overall financial activities.

Andrew H. Chen. Research in Finance 20, January 2003, various pages. For online copy, follow link from *http://207.36.165.114/Denver/Papers/DenverProgram818.htm*

Second: Low Income Housing Tax Credits (LIHTC)—In addition to providing mortgage financing to multifamily housing, Fannie Mae also works with nonprofit and for-profit housing sponsors to increase the availability of funds to affordable multifamily housing by making equity investments in properties that qualify for Federal LIHTC.

Congress created LIHTC in 1986. The credit generates about $8 billion of private investment each year to produce more than 125,000 affordable apartments for low income families and the elderly.

Properties developed under LIHTC target residents who earn 60 percent or less of the area's median income. In a 1997 study, the General Accounting Office found that average Housing Credit apartment renters earn only 37 percent of area median income. Many earn less than 30 percent.

Fannie Mae's participation in the LIHTC market provides day-in day-out liquidity to this important affordable housing market. Fannie Mae's LIHTC investments span all parts of the country and all types of properties that have received an allocation of the tax credit.

Fannie Mae's credit performance from its LIHTC portfolio has been very strong. Total losses on the total book over the 17 years of LIHTC investment activity equal approximately one-tenth of a percent.

Third: In addition to the LIP and LIHTC assets described above, as of June 30, 2006, Fannie Mae holds approximately $5 billion of other nonmortgage assets (.6 percent of our total assets). There are four types of investments in this category: (1) Debt and equity investments entered into through activities of the American Communities Fund (ACF), $2.4 billion; (2) Market-rate equity investments, $0.4 billion; (3) Tax-advantaged investments in synthetic fuels and wind energy, $7.0 million; and (4) Corporate-owned life insurance, $2.0 billion. These are described below:

- ACF Investments—ACF provides various types of financing to help meet community development needs, including: predevelopment loans to nonprofit developers, participations in acquisition, development and construction financing, and construction lines of credit or letters of credit. As an equity investor, Fannie Mae acts as a limited partner or nonmanaging member of a limited liability corporation (LLC) that invests in real estate operating properties, mezzanine loans, and historic tax credits. Fannie Mae either invests directly in a property or through a fund that holds direct investments. Fannie Mae also has investments in common or preferred shares of community development financial institutions (CDFIs).
- Market-rate Equity Investments—These investments comprise limited partner or LLC member equity interests in direct or fund investments in rehabilitation properties.
- Investments in Synfuels and Wind Energy—Between 1998 and 2000, Fannie Mae invested in limited partnerships that acquired and operated plants that produce synthetic fuel from coal and wind energy plants designed to produce electricity. The investment in plants that produce energy from nonconven-

tional sources qualifies for tax credits under the Internal Revenue Code.

- Corporate Owned Life Insurance—As is typical in major corporations, Fannie Mae has purchased corporate-owned life insurance (COLI) that covers the lives of certain directors and officers. This insurance provides a benefit to the company in the event of the death of a key employee, which reduces the costs associated with the related loss of talent, expertise, and knowledge. The company also uses these investments as a means of funding deferred compensation and supplemental retirement programs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MARTINEZ FROM DANIEL H. MUDD

Q.1. The OFHEO Report on pp. 269–271 asserts that you missed an opportunity to recognize that there were similarities between Freddie Mac and Fannie Mae's situation. Can you explain why you didn't refer the complaints by Michelle Skinner (which were confirmed by the Head of the Office of Auditing, Sampath Rajappa) to the Board Audit Committee?

A.1. The Securities Accounting employee cited in the OFHEO report, Michelle Skinner, raised the question about accounting during an open-forum, town hall-style meeting I held with employees on a regular basis, which the company called an "unplugged" meeting. In the unplugged meetings, employees are invited to ask questions on any type of issue or concern-ranging from complicated business and work issues to the food served in the cafeteria and the limits of coverage under the dental plan. In the September 9, 2003, session, Ms. Skinner asked a complex accounting question. Because I am not a trained accountant and do not have expertise in the field and because the financial accounting function did not report to me during my service as COO, I could not answer her question on the spot. So I invited Ms. Skinner to send an e-mail to me explaining her concerns in greater detail.

When I received her e-mail, I asked my assistant—a former securities lawyer—to ensure answers were provided in response to Ms. Skinner's questions. The matter was referred to Internal Audit, the General Counsel and the Controller's Office. By late September, Internal Audit provided to me its assurance that issues raised by Ms. Skinner were being handled by the company in a manner consistent with GAAP. I was also told that our external auditor, KPMG, reviewed these issues and found the treatment acceptable.

At my direction, a November 17, 2003, tutorial session was organized to address the questions that had been raised by Ms. Skinner in greater depth and in an open dialog with interested employees. It is my understanding that Ms. Skinner and Mr. Anthony Lloyd (another employee who shared similar concerns) stated that they were satisfied with the response and that their concerns had been addressed. At the time, I believed that the issues were being thoroughly reviewed and that a full and accurate response was provided by offices and individuals experienced and knowledgeable in the area. At all times, I tried to address Ms. Skinner's inquiry openly and thoroughly.

Q.2. Based on the OFHEO report (p. 34) you were describing needed changes and you stated:

> The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition . . . We used to, by virtue of our peculiarity, be able to write, or have written, rules that worked for us. We now operate in a world where we will have to be 'normal.'

Can you explain to me what you were trying to say in that memo? If you were simply operating Fannie Mae pursuant to its government charter and playing by the rules why would you have needed (in the past) to eliminate any political opposition and I am assuming you meant both Congress and more specifically OFHEO?

A.2. As discussed during my June 15, 2006, testimony, the thrust of my November 16, 2004, memorandum was in no way an endorsement of the preexisting tone and attitude at Fannie Mae. The purpose of the memorandum was to reject the preexisting tone and attitude and encourage the company to change. A central theme of the memorandum was the importance of improving our relationships with OFHEO and our other regulators, including the SEC. My memorandum was attempting to provide a "wake-up call" that change was necessary to meet the challenges of the more competitive and evolving financial markets.

For much of its life span, Fannie Mae had a practically unique position in American financial markets. This "peculiarity" meant that rules had to be created to address aspects of Fannie Mae's business that were different from other financial institutions. Thus, as my memorandum noted, we "faced little organized political opposition" during that era. However, as the financial markets have become more sophisticated and competitive, Fannie Mae became less unique and there was less need for Fannie Mae-specific rules. My memorandum does not indicate that the "old political reality" from the bygone era was appropriate. Nor did I suggest or condone any effort to eliminate political opposition. There are, and will be, strongly opposing views about the financial markets and Fannie Mae's role in that arena. Fannie Mae recognizes that robust debate in this area is appropriate and healthy.

I strongly believe that a properly functioning, professional relationship with our regulators is in the best interest of our company and the housing markets, and I have made it a top priority since becoming CEO to repair and strengthen those relationships. I have also made it clear from day one that the approach, tone, and manner with which we engage policymakers has needed to change, and I hope we have made significant strides in this regard.

Q.3. It appears that on page 37 of the OFHEO Report we have evidence of what used to be the case at Fannie Mae (e-mail dated January 13, 2003). Can you explain what you meant by "what to do if OFHEO was not falling in line?"

A.3. The e-mail related to a call I made to a Treasury official during the time Fannie Mae was seeking and preparing for our voluntary registration with the SEC—an effort I supported to improve Fannie Mae's transparency and bring the company into line with other large public financial institutions. As the date approached for

the filing of our first Form 10-K with the SEC, we learned that OFHEO disagreed with Treasury and the SEC about some aspects of the registration process. I called the Treasury official for guidance and clarification of the positions of the three agencies, solely with respect to interagency disagreements regarding the registration process.

I want to emphasize that I did not make the call to generate conflict or to interfere, in any way, with OFHEO regulation of Fannie Mae. I meant the call as a good-faith attempt to obtain guidance about our regulatory obligations as we expanded Fannie Mae's financial reporting through SEC registration.

Q.4. I'd like an explanation of your reasoning for not procuring more resources for the Auditing Department. Based on the e-mail referenced on by footnote 82 on p. 206, I assume you were aware, or at least should have been aware, that audits were being postponed or canceled. How do you explain your oversight of this issue given that you were growing your business during these years, not to mention the new compliance requirements from Sarbanes-Oxley (2002)?

A.4. That particular e-mail reflects the regular adjustment process that the Audit Department would undertake mid-year in its audit plans. The e-mail specifically indicates that the original plans were being adjusted due to the Audit Department's focus on Sarbanes-Oxley and the OFHEO Special Exam during 2004. At this time (August 2004), the Audit Department did not report to me; I was provided this e-mail as a courtesy so that I would be generally informed of the Audit Department's plans for the rest of 2004. The e-mail did not state that the Audit Department wanted or needed additional staff, but rather explained that Sarbanes-Oxley requirements and the OFHEO Special Exam (which began in 2003) had caused adjustments in the work done by the Audit Department. It made sense to me then that the Audit Department should be focused on those issues. Indeed, it was publicly reported that many American corporations were reevaluating resources and plans in light of the advent of Sarbanes-Oxley. In addition, at the time I believed that the Audit Committee and the CFO (which both had oversight responsibility for the Audit Department) were properly monitoring the Audit Department's needs and taking any appropriate steps, when needed, to provide additional resources to the Audit Department.

Q.5. Did it not occur to you that to connect the compensation of the Auditing Dept with EPS was an obvious conflict of interest? What could the auditing department possibly do to help meet the EPS of $6.46?

A.5. As I stated in my appearance before the committee, I agree that the Audit function is a very important function and a very important check that requires independence. It is critical that its compensation be independent of the company's financial results.

As Fannie Mae Chairman, Steve Ashley, said during his testimony, "during the 1990s and the early part of the decade of 2000 this was an accepted and indeed promulgated form of compensation in addition to base compensation that most of corporate America—publicly owned corporate America—engaged in one form or an-

other. The purpose was to align the management of the company with the interests of the shareholders."

The EPS goal was announced broadly—publicly and internally—when it was launched in 1999, and it remained a corporate financial stretch goal through 2003. The incentive was available to all full-time employees. And as I noted in my appearance before the committee, this was a compensation structure similar to other companies that I had worked for previously and which I thought was appropriate in those circumstances.

Fannie Mae has now adopted a new executive compensation structure with broad performance goals that include achieving affordable housing mission goals, improving our culture, complying with regulatory standards, and delivering shareholder value. In addition, Fannie Mae's Consent Order with OFHEO explicitly requires the board to ensure that our compensation practices "include financial and nonfinancial metrics and shall not be tied exclusively to earning per share" and that "compensation metrics for the internal auditor, chief compliance officer, controller, and such others, as determined in consultation with OFHEO, be appropriate to their roles and do not create a conflict of interest."

To ensure proper oversight moving forward, the board and management have completely overhauled the internal audit function to ensure it is the corporate guardian it is supposed to be. The Chief Audit Executive is a new external hire who reports directly to the Audit Committee of the board of directors with a dotted line reporting to the CEO. This position has increased direct interactions with, and enhanced detailed reporting to, the board's Audit Committee and its chair (who is a new Fannie Mae board member, Dennis Beresford, a former chair of the Financial Accounting Standards Board). The Internal Audit function also has undergone a comprehensive organizational and process redesign, including new structure, staffing levels, skill assessments, audit planning processes, execution, and reporting. The company has also replaced its outside auditor with Deloitte and Touche, LLP, which formerly provided advice to OFHEO when several of the accounting problems were first identified and is now conducting a comprehensive re-audit of the entire company with more than 300 auditors onsite at Fannie Mae.

Q.6. Next, I would like to discuss your e-mail/memo regarding restricting Board access to management. In your e-mail which begins on the bottom of page 271 of the Report, you appear to infer that in restricting the Board's access to management (essentially giving CEO /Chairman Raines sole discretion in what is communicated to the Board) is a "best in class" principle for corporate governance. Do you still believe that?

A.6. The e-mail you ask about addressed unique circumstances specific to the employee who received it, our former SVP for Human Resources, Kathy Gallo. I did not intend this communication to limit employee access to the board or its committees in general.

Here are the circumstances behind the e-mail. In 2003, Ms. Gallo told me she had received direction on specific issues from a board committee chair, Ann Mulcahy. When I discussed the matter with Ms. Mulcahy, she informed me that the Committee in fact had not

provided any such direction to Ms. Gallo. At Ms. Mulcahy's direction, I sent Ms. Gallo an e-mail—addressed to her alone (with certain appropriate people copied)—directing her to use regular channels of communication with the board and its committees to ensure a clear record of board and committee decisions. This guidance to Ms. Gallo did not limit or affect any board member's ability to seek information from any Fannie Mae employee. As indicated by the limited distribution of the e-mail, I intended it solely to address the situation that arose concerning Ms. Gallo. In addition, the channel of communication (the Office of the Corporate Secretary) identified in the e-mail to Ms. Gallo did not give Mr. Raines sole discretion over the information communicated to the board.

I believe in the principle that the board should have full and unfettered access to management and employees. Many of the organizational, structural and reporting changes Fannie Mae has made since I became CEO—within the company and with the board, and to fulfill our regulatory agreements and otherwise—are designed to ensure this access.

Q.7. Hedge accounting is of great importance to Fannie Mae because of its large derivative portfolio used to hedge interest rate risk associated with its debt issuances. The SEC announced in December 2004 that Fannie Mae's hedge accounting policies and procedures did not comply with GAAP (FAS 133). Would you explain FAS 133, the differences between the short-cut and long-haul methods of hedge accounting and their implications, particularly the potential earnings volatility, and why Fannie Mae did not comply?

A.7. Fannie Mae uses interest rate derivative instruments to manage and reduce the interest rate risk that, for all mortgage investors, is inherent in holding mortgage assets, particularly fixed-rate loans, which are our specialty. These derivatives, in essence, help us to match the duration of our liabilities (the debt we issue to purchase mortgages) with the duration of the mortgage assets we purchase.

FAS 133, *Accounting for Derivative Instruments and Hedging Activities* requires that derivatives be carried on financial statements at fair value with changes in fair value (mark) included in earnings unless the company applies hedge accounting. Thus, without applying hedge accounting, the fair value mark on the derivative is included in earnings without an offsetting mark related to the hedge item.

As I currently understand it, the so-called "short-cut" method is a provision in FAS 133 that allows for an assumption that the gain or loss on the derivative instrument will exactly offset the gain or loss on the hedged item. This method significantly simplifies the computations necessary to make the accounting entries because it does not require the periodic calculation of how well changes in the fair value of the derivative mirror changes in the fair value of the hedged item. Thus, under the short-cut method, no amount of ineffectiveness is included in earnings during the life of the hedge relationship. Companies may only apply the short-cut method if the critical terms of the derivatives precisely match the critical terms of the hedged item.

In contrast, the long-haul method requires quarterly calculations of the "effectiveness" of each hedging relationship. To the extent the change in fair value of the derivative is not offset by the change in the fair value of the hedged item, "ineffectiveness" results. Any amount of ineffectiveness is included in earnings in the period in which it occurs. As it has been explained to me, Fannie Mae applied the short-cut method to its hedging relationships under the belief that it had met the requirements of the standard. The SEC determined in December 2004 that this application of FAS 133 was not appropriate.

Q.8. Do you believe that Fannie Mae did not engage in innocuous practical interpretations or modest deviations from a strict reading of FAS 133, but the company clearly departed from FAS 133 requirements?

A.8. As it has been explained to me, Fannie Mae applied a short-cut method to its hedging relationships under the belief that it had met the requirements of the standard. The requirements of FAS 133 have challenged many companies, resulting in a large number of restatements. Prior to SEC pronouncements, the company believed that its interpretation of FAS 133 was reasonable. It has now been determined that these interpretations were not appropriate under the short-cut method.

Q.9. Mr. Raines committed to double Fannie Mae's EPS in 5 years. This strategy meant aggressively expanding the credit guarantee and portfolio investment business, with the latter offering the better prospect for growing earnings. Would you explain the interest rate risk taken and how the asset duration gap changed? Why should the board have recognized the inconsistency between reporting stable EPS growth and taking significant interest rate risk and implementing FAS 133 properly?

A.9. Interest rate risk is the risk of loss to future earnings or long-term value that may result from changes in interest rates. Fannie Mae's principal source of interest rate risk stems from holding mortgages that homeowners may prepay at any time without penalty. The so-called "borrower's option" is a fundamental underpinning of the U.S. system and is made possible by the GSEs' liquidity function. The cash-flows from mortgage assets are highly sensitive to changes in interest rates because of the borrower's option, exposing the company to interest rate risk because the cash-flows of mortgage assets and the liabilities that fund them are not perfectly matched through time and across all possible interest rate scenarios. As interest rates decrease, borrowers are more likely to refinance fixed-rate mortgages, resulting in increased prepayments and mortgage cash-flows that are received earlier than expected. Conversely, an increase in interest rates may result in slower than expected prepayments and mortgage cash-flows that are received later than expected.

The company assesses exposure to changes in interest rates using a diverse set of analyses and measures, including the duration gap. The duration gap is the difference between the estimated durations of portfolio assets and liabilities. Duration gap summarizes the extent to which estimated cash-flows for assets and liabilities are matched, on average, over time and across interest rate

scenarios. A positive duration gap signals a greater exposure to rising interest rates because it indicates that the duration of assets exceeds the duration of liabilities. A negative duration gap signals a greater exposure to declining interest rates because the duration of the company's assets is less than the duration of its liabilities. It should be noted that the duration gap reflects the mortgage portfolio at a point in time and not projected future business activity. Since October 2000, the company has publicly disclosed its duration gap on a monthly basis.

Prior to 2003, the company maintained a preferred range for its duration gap of plus or minus 6 months. From 1992 to 2002, the company's duration gap was wider than plus or minus 6 months approximately one-third of the time. The company's duration gap experienced a negative shift during 2002 primarily as a result of a significant decline in interest rates that resulted in a surge in mortgage refinancing activity. The significant increase in expected mortgage prepayments caused the durations of the company's mortgages to shorten by more than the duration of the company's debt. The company's duration gap peaked at minus 14 months in August 2002 before narrowing to minus 5 months by the end of the year. The reduction in the duration gap was accomplished primarily through portfolio rebalancing action taken by the company. For all of 2002, the company's duration gap was wider than plus or minus 6 months in 3 months of the year, slightly less than the company's historical average of approximately one-third of the time.

Beginning in 2003, the company has followed a risk discipline that requires a duration gap of plus or minus 6 months substantially all of the time. To maintain the duration gap within this tighter risk tolerance, the company began taking rebalancing actions earlier and with more frequency than it previously had. The company's monthly duration gap has been within the range of plus or minus 6 months in every month since October 2002, and has been within a range of plus or minus 1 month in every month since October 2004.

Fannie Mae's financial results as measured under generally accepted accounting principles (GAAP) do not capture the full impact of changes in the fair value of our mortgage assets or our debt. Hence, changes in fair value of the mortgage assets or debt due to changes in interest rates are only recognized in earnings when realized through assets sales or debt repurchases. Conversely, GAAP requires derivatives to be measured at fair value with changes in fair value recorded through earnings unless a qualifying hedge accounting relationship has been established. As a result of this GAAP mismatch, without hedge accounting, even if the duration gap is managed to zero, earnings and EPS volatility will result from the changes in the fair value of derivatives. It is equally possible that a financial institution exposed to interest rate risk from a significant duration gap could expect little short-term GAAP earnings and EPS volatility because their derivatives have been appropriately designated in hedging relationships.

Q.10. Fannie Mae buys derivative instruments that will offset the impact of interest rate movements on the company's debt obligations and thereby maintain its spread. The notional amount of

their derivative portfolio passed the $1 trillion mark in 2003. Their menu of hedge transactions has increased to approximately 70 different combinations of debt and derivatives. Fannie Mae's debt is sold primarily to purchase mortgages and mortgage-backed securities (MBS) to hold in portfolio. What is your view of the risk and complexity involved in managing this retained portfolio? The retained portfolio is considerably more profitable than guaranteeing MBS. Is this an example of the earnings at any cost culture at the company? What, if any, correlation is there between the size of the portfolio and the company's achievement of its mission?

A.10. Fannie Mae is one of many large U.S. financial institutions, including large federally insured commercial banks—that have and manage a retained portfolio of residential mortgages. Fannie Mae's portfolio holds only about 7 percent of the $10 trillion mortgage debt outstanding assets, and the retained portfolios of some of the largest banks are growing, with one beginning to rival the size of Fannie Mae's (Bank of America's is nearly $500 billion).

All mortgage investors face similar risks and complexities of managing their mortgage portfolios. Fannie Mae differs from most other mortgage investors in two major ways. First, unlike most of these other mortgage investors, Fannie Mae invests exclusively in residential mortgages—among the safest assets in the world—which allows us to focus on managing their risks, making it less complex for us than managing the range of assets that others do. Second, Fannie Mae's ability to raise capital by issuing debt securities in various and variable durations gives us the ability to match our funding with the mortgages we purchase and hold, and thus better manage the risks effectively.

Regardless of our profitability, Fannie Mae has managed a retained mortgage portfolio since our inception in 1938 for a critical reason: to achieve our chartered purpose of providing liquidity to the housing finance system by raising capital globally and domestically, and purchasing mortgage assets, providing lenders with a steady supply of funds, at favorable rates and terms, in all markets across the Nation under all economic conditions. Indeed, as a result of their charters, the GSEs are the only mortgage investors that are required to be in all markets at all times, even when banks and other investors pull away.

The 70 different combinations of debt and derivatives cited in the question refers to the accounting classifications Fannie Mae had historically used in linking its derivatives to specific debt issues or anticipated debt issues. The types of derivatives used fall into only four classes: (1) interest rate swaps; (2) interest rate swaptions; (3) interest rate caps; and (4) foreign currency swaps. Interest rate swaps are among the most liquid derivative instruments in the market, and are used to manage the duration of the portfolio. Swaptions and caps are used to manage the prepayment or convexity risk of mortgages we own. The smallest group of derivatives we use are foreign currency hedges which basically swap all debt we issue denominated in foreign currency into U.S. dollars.

It also should be noted that the mortgage portfolio is not always our most profitable business, nor is it "considerably more profitable than guaranteeing MBS." Any of our businesses, like those in other institutions, may be more or less profitable at a given time.

Q.11. The company claimed its hedges exactly matched its risk exposure in the portfolio when it did not. Critics focus on the extent of interest rate and prepayment risk, but shouldn't the risk involved in accounting for the derivatives and hedging be a major concern?

A.11. Fannie Mae uses interest rate derivative instruments to adjust the duration of our debt to manage the interest rate exposures of our mortgage related assets. The reasons why we enter into derivatives—to allow us to manage our interest rate exposures—is unaffected by the accounting.

As with any complex accounting standard, and particularly in the case of FAS 133, subjective judgments and interpretations are required that create risk that there could be differing interpretations. Many of the most complex interpretations of FAS 133 relate to hedge accounting. Given the challenges presented by the hedge accounting requirements, Fannie Mae is not currently applying hedge accounting.

Fannie Mae's financial results as measured under generally accepted accounting principles (GAAP) do not capture the full impact of the changes in the fair value of our mortgage assets or our debt. Hence, changes in fair value of mortgage assets or debt due to changes in interest rates are only recognized in earnings when realized through assets sales or debt repurchases. Conversely, GAAP requires derivatives to be measured at fair value with changes in fair value recorded through earnings unless a qualifying hedge accounting relationship has been established. As a result of this GAAP mismatch, without hedge accounting, even if the duration gap is managed to zero, earnings and EPS volatility will result from the changes in the fair value of derivatives. It is equally possible that a financial institution exposed to interest rate risk from a significant duration gap could expect little short-term GAAP earnings and EPS volatility because their derivatives have been appropriately designated in hedging relationships. That said, our number-one corporate priority is to complete the restatement under this, and other accounting standards, and we are leaving no stone unturned to do the job right.

Q.12. The controller's office lacked adequate staffing and systems, as well as sufficient accounting and financial reporting expertise for a company as complex as Fannie Mae. The Controller, at one time, was not a certified public accountant. What, if any, active support did this office receive from senior management, especially following the company's voluntary SEC registration and what steps has current management taken?

A.12. Overall, the company has established a new management team, particularly in the critical control functions, including finance, accounting, audit, and risk to provide the leadership, experience, talent, and ethical standards necessary for a company with the scope of Fannie Mae. In cooperation and consultation with our regulator, we are fundamentally reorganizing the company to ensure that strong checks and balances are in place. The standard the company has put forth during the transformation in this regard is straightforward—the average businessperson should be able to

look at the organization chart and understand key roles and responsibilities and identify clear checks and balances.

The company has a new Chief Financial Officer, a new Chief Risk Officer, a new Chief Audit Executive, a new Senior Vice President for Accounting Policy, and a new Controller. As part of the Controller's department, we have bolstered the staffing considerably with 17 officers working in this area compared to five previously. Accounting policy, accounting application and budgeting are all separate now, with each group headed by new senior leadership from Big Four accounting firms or major corporations and eight of the staff, including the Controller himself, are certified public accountants.

The company has taken other concrete steps in this regard:

- The CFO, Robert Blakely, who headed up the restatement at MCI, does not run a business—he is focused solely on Finance.
- To ensure proper oversight, we have reorganized and strengthened Internal Audit, and the new Chief Audit Executive has a direct and independent reporting line to the board's Audit Committee. The board's Audit Committee is now chaired by Dennis Beresford, a former member of FASB who joined the board this year.
- The company has replaced its outside auditor with Deloitte and Touche, which formerly provided advice to OFHEO when several of the accounting problems were first identified and is now conducting a comprehensive re-audit of the entire company with more than 300 auditors onsite at Fannie Mae.
- To integrate strong risk management into the accounting, controls, and audit areas and throughout the entire enterprise, the company has put in a place a strong risk management function headed by Chief Risk Officer Enrico Dallavecchia. Mr. Dallavecchia had been with JP Morgan Chase as head of market risk management, and he comes to the company with almost 20 years of experience in banking and risk management.
- As part of the company's restatement and remediation efforts, Fannie Mae has invested hundreds of millions of dollars in new systems to ensure that the company's technologies in this area will meet high standards, ensure proper controls, and fully support the accurate and transparent financial reporting required of an SEC registrant.

Q.13. The head of internal audit did not have training or experience as an auditor. Internal audit had to clear communications with the board's audit committee through senior management and told the committee that Fannie Mae's accounting complied with GAAP, when it actually audited only for compliance with the company's policies interpreting GAAP. What steps have been taken to reorganize the internal audit function?

A.13. Management and the board's Audit Committee appointed a new Chief Audit Executive, Jean Hinrichs, from outside the company who reports directly to the Audit Committee with a dotted line to the CEO. The Chief Audit Executive has over 25 years of internal audit and risk management experience. She has increased direct interactions with the board's Audit Committee and its chairman, and enhanced detailed reporting to the committee monthly.

The Internal Audit function has implemented a comprehensive organizational and process redesign, including a new structure, staffing levels, skill assessments, audit planning processes, execution, and reporting.

As part of the organizational restructure, the Internal Audit department has three new vice presidents who have an average of 23 years of experience in audit and risk management with top-tier financial institutions and public accounting firms. As a result of targeted recruiting and training, the Internal Audit department has 20 certified public accountants and 70 percent of the department has an auditing, accounting or technology professional certification.

Q.14. Fannie Mae voluntarily registered its stock with the SEC; as a result, the enterprise was required to comply with Sarbanes-Oxley, effective in 2004. The OFHEO Report states: "Although the Office of Auditing lacked the requisite knowledge, skills, and resources, Fannie Mae delegated to the Office the responsibility of building and maintaining the SOX 404 compliance system." This addition to existing duties was "overwhelming." How has this affected the company's SOX compliance?

A.14. The Internal Audit department had project oversight for the company's efforts to develop and assess internal control over financial reporting in 2004 pursuant to Section 404 of the Sarbanes-Oxley Act and related rules of the SEC. The department coordinated with KPMG, the company's independent auditor at the time. Upon announcement of the restatement and senior management changes, the company engaged PricewaterhouseCoopers LLP (PwC) to assist with SOX 404 compliance efforts. The company also engaged Deloitte and Touche LLP as its new independent auditor.

With the assistance of PwC, we have been assessing the effectiveness of our internal control over financial reporting that existed as of December 31, 2004, and as of December 31, 2005. To date, we have identified control deficiencies in a number of areas, including: financial systems and other information technology systems; entity-level controls relating to risk oversight, staffing and expertise of the internal audit and accounting departments, and documentation of policies and procedures; design and application of accounting policies; the valuation of our assets and liabilities; and financial reporting processes. We expect to conclude that many of these identified deficiencies are either material weaknesses or significant deficiencies that in the aggregate constitute material weaknesses. We also may uncover additional deficiencies as this assessment process continues.

Management has taken a number of steps since December 2004 to address control deficiencies, including completely reorganizing the company's finance area and hiring a new Chief Financial Officer, a new Controller, a new Chief Audit Executive and several other new accounting officers, reorganizing the company's risk management and corporate compliance functions and appointing a new Chief Risk Officer and a new Chief Compliance and Ethics Officer.

Our report on internal control over financial reporting in our Annual Report on Form 10-K for both 2004 and 2005 will conclude that our internal control over fmancia1 reporting was ineffective

due to the presence of material weaknesses. Our reports for 2004 and 2005 will identify material weaknesses and address our plans for remediation. We believe that Deloitte and Touche will not be able to issue opinions on the effectiveness of our internal control over financial reporting as of December 31, 2004, or on management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004, but will be able to issue these opinions in connection with our internal control over financial reporting as of December 31, 2005.

Q.15. It is my understanding that the size and aggressiveness of the company's lobbying and grass roots activities have been substantially reduced. Can you give me more specifics about in-house and external activities in terms of personnel, costs, and approach?

A.15. Management and the board have made establishing a new tone, manner, and approach in the way we communicate with policymakers a top corporate priority. Specific actions taken include:

- The company discontinued retainers with six outside lobbying firms since the end of 2004, though contractual obligations required additional retainer payments to some firms in the first quarter of 2005.
- The company discontinued all advocacy advertising.
- The total operating expenses for the internal Government and Industry Relations Department decreased by 21 percent from 2004 to 2005.
- Fannie Mae continues to reduce its external lobbying costs, and remains committed to its overall objective of cutting external lobbying retainers by one-third from previous levels.
- The company discontinued its regional public affairs director positions, and has restructured its Community Business Centers to focus on supporting local business objectives.